

**FUTURES TRADING PRACTICES ACT OF 1989—
S. 1729**

HEARINGS

BEFORE THE

**COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY
UNITED STATES SENATE
ONE HUNDRED FIRST CONGRESS**

FIRST SESSION

ON

S. 1729

TO AMEND THE COMMODITY EXCHANGE ACT TO REAUTHORIZE SUCH
ACT, AND FOR OTHER PURPOSES (FUTURES TRADING PRACTICES ACT
OF 1989)

OCTOBER 17 AND 18, 1989

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FUTURES TRADING PRACTICES ACT OF 1989— S. 1729

TUESDAY, OCTOBER 17, 1989

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room SH-216, Hart Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Harkin, Conrad, Fowler, Daschle, Kerrey, Lugar, Cochran, Boschwitz, McConnell, Bond, and Gorton.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. Good morning. I must say, this hearing room is a little bit more difficult to get used to than our normal Agriculture Committee hearing room. But we thought we would meet here in honor of our former colleague, Senator Eagleton. Also, we found that we didn't have enough seats in the committee hearing room.

I'll be very brief in my opening statement because we have a number of things to cover. Senator Lugar will be here later. He is at another matter that he cannot get out of right now.

During this past year, regulation of the futures industry has lurched from crisis to crisis.

We've seen a "sting" operation exposing widespread fraud in the trading pits, a CFTC report criticizing audit trading systems, and a soybean emergency exploding in July.

The system has simply not worked. Rules have been ignored; customers have not been protected.

Without the public's trust, futures markets cannot function. They cannot serve the needs of our country.

This unique American institution stands in serious danger of being changed unalterably and for the worse.

We cannot—and will not—tolerate abuses of the system.

Criminals will be punished. Weak laws will be strengthened. Law enforcement officials will be given the tools to crack down.

S. 1729, introduced by myself, Senator Lugar, and Senator Kerrey, is a tough bill. It demands tough solutions for tough times.

With Senators Lugar and Kerrey, I plan to move this bill on a fast track. We introduced it 2 weeks ago; we plan to move it through the Senate this year.

Today, we are here to discuss that legislation. We cannot finish this CFTC reauthorization, however, without examining last Friday's stock market plunge.

For this reason, I have sent CFTC Chairman Wendy Gramm a letter asking her to analyze last Friday's events, paying particular attention to the cooperation of Federal and exchange officials, reforms instituted after the 1987 crash, and the financial integrity of the markets.

The report from the Chairman, of course, will be of great help to this committee.

We will enter the prepared statements of Senators Lugar and Harkin at this point in the record.

[The prepared statements of Senators Lugar and Harkin follow:]

OPENING PREPARED STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Mr. CHAIRMAN. Last week we introduced S. 1729, the Futures Trading Practices Act of 1989. This bill represents the most significant reforms of the Commodity Exchange Act in the 15-year history of the Commodities Futures Trading Commission.

The bill provides the CFTC with the tools and enhanced regulatory authority to monitor trading activity on the floors of the various commodity exchanges and to take strong action to deter and hopefully eliminate trading abuses. Strong penalties of \$500,000 and greater are designed to encourage compliance with CFTC directives.

It is important to create a regulatory environment that will ensure that the U.S. markets continue their international preeminence in futures trading. The U.S. markets are a vital element to risk transfer. Futures markets are a valuable national resource and as such must be maintained and protected.

But to the investors that use these markets, the chief issue is confidence and integrity in the market. Corruption and market manipulation of the magnitude noted in the FBI investigation severely damages any perception of market integrity and undermines investor confidence in these markets.

In order to protect and maintain these markets, the goal of this committee is to foster a trading environment that is of unquestioned integrity. Only then will the public maintain the confidence necessary to continue the U.S. leadership in the worldwide futures trading arena. Only then will the Commodity Futures Trading Commission maintain the integrity to remain the chief regulatory body of the futures industry.

Mr. Chairman, I look forward to hearing from today's witnesses. Various segments of the futures industry have raised concerns about provisions contained in the bill, in particular the provisions dealing with the audit trail and certain penalties. I welcome the opportunity to hear those concerns specifically and in detail.

PREPARED STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA

Thank you Mr. Chairman. I don't need to recount the troubling events in the futures markets this year. We all are familiar with them. The message that comes through loud and clear is that there are serious problems and that farmers, customers and the public are entitled to answers and solutions. I commend you Mr. Chairman for your leadership and commitment to solving these problems.

There are two general aspects to these problems. First, there is the reality of dishonesty and trading abuses in the pits that have been documented in earlier hearings. Second, and in some respects more important, confidence in the integrity of the futures markets has surely hit an all time low. There must be confidence in the integrity of these markets if they are to function properly, but there will not be such confidence until real integrity to support it is assured.

Rightly or wrongly, farmers have long suspected that the futures markets are rigged against them and that they are at the mercy of the arcane world of the futures trading pits. Even if farmers are not trading in the futures markets themselves, the prices they receive on the cash market or through forward contracts are established by the futures markets. Unfortunately, the events of this year confirmed for many farmers their worst suspicions about the futures markets. Farmers need to

have confidence that the market is honest and that it accurately reflects the true market situation. They don't have that confidence now.

The commodity futures markets are essential to agriculture and other basic industries and are increasingly important to our financial sector. We cannot let the current problems be the downfall of this industry. So confidence in these markets must be rebuilt on a solid base.

It is imperative that the CFTC and the futures exchanges do a much better job of carrying out their responsibility to protect farmers, customers and the public and to ensure the orderly and fair functioning of these markets.

The events of this year have truly set up a trial by fire of the principle of self-regulation by the futures exchanges. In view of these events, their plainly will be stronger laws governing the exchanges. Today's hearing will help to define the shape of these changes. I certainly do not favor extensive new laws simply for the sake of regulation. I fully appreciate the need to maintain efficiency and international competitiveness in the U.S. futures markets by avoiding unnecessary regulation. However, the integrity of the futures markets and confidence in those markets are closely related to efficiency and ultimately are elements of the competitiveness that will allow this industry to remain in the United States.

The futures exchanges and the CFTC are taking steps to address these problems, but we must be assured of real and substantial progress. We must carefully consider how the tradition of self-regulation by the exchanges comports with the critical need to reform.

I look forward to working on this legislation with the benefit of today's testimony and the ideas of all parties that such legislation would affect.

The CHAIRMAN. Senator Kerrey.

STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Mr. Chairman, very quickly, I support your opening statement and I would indicate that the difficulty that I'm having in considering not only the changes proposed in S. 1729, but also the whole question of reauthorization, is that—and Senator Leahy stated it very well—there's been a collapse of confidence in the whole scheme of self-regulation over the past 9 months. The retreat began with strong statements from the exchanges that everything was pretty well under control, that we shouldn't worry too much about the FBI investigations that were going on, and that the industry is on top of the situation. Then the indictments came down. The Ferruzzi incident followed shortly after that, and the confidence that we had evaporated as a consequence of this entire series of events.

I am at a point now where I'm beginning to call into question many of the basic underlying premises that I had previously accepted as articles of faith. And I appreciate, Mr. Chairman, the opportunity to join you and Senator Lugar as a cosponsor of S. 1729. I also appreciate your efforts throughout the year in directing our attention to this very important matter.

The CHAIRMAN. Thank you very much, Senator Kerrey.

Our first witness is Senator Thomas Eagleton. I might say just as a personal statement, when I look back, what I have found most rewarding of my own experience of being in the U.S. Senate is serving with Tom Eagleton. We served on different committees together, most recently, of course, is the Senate Intelligence Committee. I found Senator Eagleton to be a Senator who asked the right questions and keeps on asking them until he gets the answers. He's also a Senator who took his job seriously here, and was one of those who, when he left, when we all went on to the floor to make our usual statements of goodbye, this was a case where the expres-

sions of regret that he was leaving were actually honestly made by Senators on both sides of the aisle.

Senator Eagleton.

STATEMENT OF HON. THOMAS F. EAGLETON, MEMBER, BOARD OF GOVERNORS, CHICAGO MERCANTILE EXCHANGE, FORMER MEMBER OF THE U.S. SENATE, ST. LOUIS, MO

Senator EAGLETON. Thank you, Mr. Chairman. I appreciate your invitation to be here today to testify on S. 1729 and related matters. I am a former member of the U.S. Senate, 1968-1987. After leaving the Senate, I became a member of the Board of Governors of the Chicago Mercantile Exchange. I am still a member of that board.

Insofar as the prevention of misconduct is concerned, the futures exchanges of America operate on three longstanding, interrelated tenets—or articles of faith, as Senator Kerrey would put it—all of these tenets, all three of them, I am sad to say, are false.

TENET NO. 1, SELF-REGULATION

One, self-regulation is deemed to be the be-all and the end-all in assuring the integrity of the futures exchanges.

Mr. Chairman, the futures industry deals in billions and billions of dollars and in millions and millions of transactions. In terms of its fiduciary relationship to the public, it is akin to a bank or a savings and loan. No one would espouse, especially today, that the banking or the S&L industry be collectively self-regulated. No one can expect any industry at all times to put the public interest ahead of its pocketbook interest. "Greed" and "temptation" are still in Webster's dictionary.

FALSE TENET NO. 2, BENIGN GOVERNMENTAL SUPERVISION

Two, benign governmental supervision. Here's how this one plays in the futures world. Well, if folks won't buy our self-regulation pitch, let's make sure that whatever the Federal Government does falls somewhere between benign and timid.

Fulfilling this prophecy, we have the Commodity Futures Trading Commission—just about as benign and timid as they come. Somehow, Congress designed it to be timid and has kept it timid by inadequate funding and a 3-year reauthorization cycle which keeps the agency in perpetual fear for its own existence.

At one of the Mercantile hearings we held in New York, a former member of the Commodity Futures Trading Commission said that when he was on the Commission, the last year of the 3-year cycle was spent devoted almost entirely to trying to get reauthorized. That's all that was on anybody's mind: We have to get reauthorized. The staff spent most of the year worrying about that. That's how it was; I suspect that's how it still is.

Perhaps 90 to 95 percent of the CFTC's professional staff time is tied up with processing routine, albeit necessary work, but routine. Only 5, maybe 10 percent of its time—maybe as few as 25 to 35 professional people—are available to respond to various major policy needs. When something like a Ferruzzi soybean matter breaks, the CFTC is overwhelmed; indeed, it approaches paralysis. It cannot re-

spond to other needs. As demonstrated in the FBI Chicago sting, the CFTC, throughout its entire existence, has been mostly too little and mostly too late.

Mr. Chairman, if the CFTC is to remain as a separate independent agency, it should have full authority to monitor and investigate the futures industry on an active, ongoing basis. Your Senate bill moves significantly in that direction. It should have the power to conduct undercover operations and the financial wherewithal to conduct these in the pits where the big action is in play. Both the Senate and House bills provide for this. It is absolutely imperative.

During the sting operation, the limited number of FBI agents with relatively small "play money" were operating in the small pits, and yet dozens of indictments came out of that. But the big pits, where the truly big money is and the big action takes place, they were uncovered. Why? Not enough FBI agents and not enough "play money." So undercover operations in the future need adequate people and adequate money to play where the real action is. Then you'll get some results. It is absolutely imperative.

On the other hand, if the CFTC is always to be treated as a regulatory stepchild, then I think it should be folded into the SEC. This remedy, this SEC remedy, is no panacea, but is certainly better than today's status quo.

FALSE TENET NO. 3

Three, too much regulation in the name of integrity will bog down the markets and will dampen market liquidity.

There's a rather likable old futures guy from New York who loves to say: "OK, you want honest markets, do you? I'll tell you how to have honest markets. Shut 'em all down." To put a reverse spin on this "enlightened" statement, this likable old pro is saying: "If you want active and liquid futures markets, they have to be crooked." Hogwash, or some other similar word.

In the era of supertechnology, you can have fully liquid and fully active markets and still offer responsible monitoring and enforcement of the law. Crookedness need not be the indispensable grease of America's futures markets.

The futures exchanges, with their open outcry systems, invite illegalities, self-dealing, and customer abuse. Open outcry may have served a purpose in the era of the quill pen and Ebenezer Scrooge, but it serves absolutely no purpose in the age of GLOBEX, invented by the Chicago Mercantile Exchange and embraced by the Chicago Board of Trade. It's a 24-hour automated international trading system. How is it that electronic trading can be an historic breakthrough 24 hours around the clock in Singapore and Hong Kong, but it's a dreaded evil in Chicago and New York? Fully electronic trades leave an audit trail that can be verified. If there are two words that ought to be the motto of these hearings, those two words are "audit trail." Simply put, open outcry in pits of hundreds of shouters, winkers, gesticulators, and body touchers cannot be adequately verified and monitored. The provision of the Senate bill which deals with "the next generation of audit trail technology" addresses this issue—just so long as open outcry doesn't somehow remain as part of the "next generation."

Mr. Chairman, I agree with the overall thrust of the Senate bill. It's an excellent piece of work that, I am sure, can be successfully blended with the House bill.

I have one other thing to add.

The CFTC should be mandated to establish minimal educational and training standards and monitor the training, education, and continuing education courses of both new, incoming, and old traders and brokers. A cosmetologist receives more training for his or her trade than do the new traders and brokers at our Nation's futures exchanges. No doubt about that. More time is spent in training for cosmetology than in training to be a trader. As one veteran Merc trader has stated, one of the most respected senior traders, "We've got a lot of people out there that shouldn't be out there." "Out there" meaning on the floor of the Mercantile Exchange. There are a lot of them out there.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Eagleton, no one can say that you have sugar-coated your testimony today. I have discussed this issue with you before, and you have corresponded with the committee before. I find your testimony extremely important. I might also say that in many ways the Chicago Merc deserves a lot of credit for putting you on the board as a public director. I suspect you've been anything but cozy coming over there and I give them credit for making sure that they have a public director who is willing to speak out.

Do you feel that there are enough public directors on the governing boards of the futures exchanges? Are the governing boards diverse enough to ensure that the public interest actually gets heard? It's obvious by your testimony here that you are not being given a party line and told that this is what you are going to say. I don't think there's anybody in the Chicago markets who gave you your testimony and said go ahead and say this. You have stated something entirely different from what we normally hear, or ever have heard, at least during the 15 years I have been here working on the CFTC reauthorizations. Are there enough public directors? Is there enough diversity?

Senator EAGLETON. No, there's not enough diversity. The board room seems about as big as this hearing room. In terms of public directors, there's myself and Susan Phillips, who used to be the Chairman of the Commodity Futures Trading Commission. She's now a vice chancellor or vice president of the University of Iowa. Then there are three or four people who are in New York involved in the futures industry and who use the exchange. They are "insiders" who happen to operate outside of Chicago. I don't think really they're "public members." Everybody else is in-house Chicago. So in terms of outside, unconnected public members, there are 2 out of perhaps 25 or 30.

The CHAIRMAN. To the extent that you see weaknesses in the regulation of the futures trading pits, is the problem primarily at the exchanges or primarily at the CFTC? Or how would you allocate the problems?

Senator EAGLETON. Well, my testimony attempts to put it on sort of an even balance. The CFTC is emasculated, as I say, timid, and only responds after calamity occurs, whether it's the soybean ca-

lamity or silver or potatoes or whatever. Only then does the CFTC perk up. Other than that, it's Sleeping Beauty.

Now, as far as the exchanges are concerned, they go through this notion of self-regulation. They really believe in it; a lot of them do. They think they're really regulating themselves. They really think they're exercising a lot of oversight over themselves. It isn't working, as Senator Kerrey has pointed out. The sting operation alone shows that it's not working.

The CHAIRMAN. You don't think that the exchanges are doing enough to crack down on abuses in their own trading. Are they making an effort at it? Are they making a good-faith effort but are limited by personnel? Or are they just ignoring the problem? How do you see it?

Senator EAGLETON. No, it's not a total ignoring of it. They have what's called a Compliance Division. They have a former SEC enforcement-type person who heads it up, and they poke around here and there on the floor. But they're very timid themselves. Self-regulation in this kind of an industry is simply not attainable. They're going through the motions. They think they're going through them zealously, but the end results are not there.

The CHAIRMAN. You said earlier that one problem for the CFTC is the short term of its reauthorization. What would you do? Would you give it a permanent authorization? Or would you make it 5-years, 10-years—

Senator EAGLETON. No, I'd make it permanent. I would make it no less impermanent than any other regulatory agency. The reason for the original reauthorization concept was, well, this is a brand new in thing, we're just starting this out, we're going into these markets, let's see how it does or doesn't do. Well, it hasn't done very well, but one of the reasons it hasn't done very well is this overhang over its existence. They get very worried at the CFTC about what Congress is going to do; they get all excited about and what the exchanges are going to get all excited about. The CFTC is one of the few regulatory agencies that I know of that stands much in fear of the very people whom they're regulating. If the CFTC were given permanent status, then this self-defeating anxiety might go away.

The CHAIRMAN. Should they also get service fees of some sort from the industry that benefits directly from its activities?

Senator EAGLETON. Absolutely. I think the budget of the CFTC is going to have to go up, and part of the "up" ought to be service fees.

The CHAIRMAN. I have one last question. If the major exchanges want to, could they implement the new computerized audit trail technologies which we call for in S. 1729? In the bill, we use the GAO's 3-year timetable. Do you see any reason why it could not be done within that 3-year period?

Senator EAGLETON. I don't have the background to ordain what the precise year period ought to be. The GAO period seems good enough to me. But I know this: I know that this technology will be there. Do not buy the notion that they'll never be able to achieve it technologically. When they leave Chicago, they brag about the technology that they invented for every other city in the world—as

I mentioned, Hong Kong, Singapore, and everywhere else. If they can do it all over the globe, they can certainly do it in Chicago.

I'll pass on whether it's 3 years or 2½ or 3½. I'll leave that up to you and the GAO.

The CHAIRMAN. So we can keep the Missouri "bond" going here—I'm sorry, that was a terrible pun—I will yield to Senator Bond from Missouri.

**STATEMENT OF HON. CHRISTOPHER S. "KIT" BOND, A U.S.
SENATOR FROM MISSOURI**

Senator BOND. Thank you, Mr. Chairman. It is a pleasure to be with you today to discuss the bill with a wide range of experts, and I'm particularly pleased to see my predecessor and good friend, Tom Eagleton.

Senator, I'm glad you have some views on this. With a good deal of enthusiasm, you've put forth your ideas on what needs to be done.

I've had the pleasure, Mr. Chairman, of discussing this with Senator Eagleton previously, and we certainly appreciate his testimony today.

You know, 1989 has been a very eventful year for our Nation's futures exchanges. We began with the indictment of 46 traders in Chicago; then there was the summer soybean crisis; and last Friday's plunge in the stock market which had an impact on all the markets and also focused new attention on Chicago and the other exchanges. We're very concerned that farmers, processors, small investors continue to have legitimate concerns that adequate safeguards be in place to prevent actions or activities that would be harmful to their livelihood.

I think the reauthorization bill gives us an excellent opportunity to implement changes, where needed, to increase oversight and ensure accountability. I think we also must be careful not to regulate some market participants out of business. We have to take note in our actions, as the CFTC must take account in its actions, of the special circumstances of smaller exchanges, some of which account for fewer than 1 percent of the contracts traded in a given year, yet they play a key role in the contract market.

In our zeal to impose the highest standards on the larger exchanges, I think we have to take account of what special circumstances there may be in some of the smaller exchanges and not require them to achieve advances that are beyond their capability.

I know that we have much good information to hear today. I would only ask Senator Eagleton a couple of questions. I apologize, Tom, that I missed the first part of your testimony. You may have touched on this then, but Friday and yesterday we had the first opportunity to witness the action of the reforms brought about as a result of the 1987 problem. It's clear that this was not a panic on the scale of Black Monday of 1987, yet we did have a few people nervous. Some of the circuit breakers clicked in, and we don't yet know how this week will play out.

Based on what you've seen to date, do you feel that the reforms that came about as a result of the 1987 crash are working? Did

they make a positive contribution? How do you assess the actions of Friday and yesterday?

Senator EAGLETON. Senator, I think the jury is still out on that issue. Yes, some of the circuit breakers on the futures exchanges did click in on Friday. Yes, Monday was not down 508 points, as was true on October 19, 1987. Frankly, I think you have to give credit for yesterday to the Federal Reserve System and to the weekend interval. Thank God for the weekend. If it had been successive days, the result might not have been as good. But the weekend, 2 days, intervened. And Mr. Greenspan, to his credit, came into action.

Senator BOND. I'll make a note of that. Alan will appreciate that. The CHAIRMAN. Call Alan right after the meeting.

Senator BOND. Yes, we'll get through to him. But there was a weekend between October 16 and October 19, and the Federal Reserve played a very important role. Some would say the Federal Reserve is the only thing that saved us from disaster in 1987 as well.

Senator EAGLETON. Yes, but the Fed didn't swing into action until Tuesday the 20th. The stock market was 100 points down on Friday, then the weekend, then the 508 on Monday, then Mr. Greenspan, who was giving a speech in Texas, got into action on Tuesday. This time it was considerably more advanced. This time the Fed used the benefit of the weekend to get ready to act immediately on Monday, not waiting until Tuesday.

Senator BOND. All right. One of the things that you suggested is the limited nature of the board makeup. If you've had a chance to look at the draft bill, do you have any comments about what is mandated in terms of board makeup? What about the makeup of the disciplinary boards? Do you think that we in Congress ought to mandate who should be represented? Should that decision be made at the CFTC level?

Senator EAGLETON. I suspect that if Congress leaves it to be made by the CFTC, it won't be made at all. So, although under normal circumstances I would perhaps leave that to the CFTC, under these circumstances, with the past track record of this agency, I think Congress might be wise to make the decision. So I think you will have to legislate a minimum of x percent—what does the bill say, 20, 25 percent?—of truly public members. Then you will have to legislate a minimum insofar as who serves on the disciplinary committees, et cetera.

As you recall, Senator, when you were Governor of Missouri, I helped create something called the "independent hearing examiner." All of the hearings for discipline before all of the State regulatory boards had to be held before the independent hearing examiner. The futures people will tell you, only we insiders understand all this terminology and all the complexities; we're the only ones who really know this business—meaning that the whole judicial and jury system of this country is cockeyed; meaning that judges don't know and that Senators don't know. Only the "insiders" know how to judge "insiders." That's crazy.

So I'd have an independent hearing examiner hold hearings on all serious disciplinary violations. Meaning "serious," those that could result in revocation of membership.

Senator BOND. You have criticized the CFTC as "a sleepy pygmy in comparison to the SEC." Do you think the changes contained in this bill address those concerns? Do you feel that more drastic remedies such as you have hinted at in the past would be required?

Senator EAGLETON. Well, I'd pretty much settle for the bill as written. But what you cannot guarantee is the zeal of the CFTC to enforce. You can give them a new law. You can give them new authority. You can even enhance the staff a little. But if the policy of the CFTC is to sit back and watch the passing parade, then we're not going to be all that much better off. So it's the motivation, the intent, and the will to enforce of the CFTC that is just as important as any bill that you pass.

Senator BOND. Tom, thank you very much for your testimony. I have a feeling our next witness may show some of that zeal and some of that enthusiasm.

Mr. Chairman, I thank you for the opportunity to participate.

The CHAIRMAN. Thank you very much.

We will have Senator Kerrey, Senator Conrad, and Senator Daschle, in that order.

Senator Kerrey.

Senator KERREY. Senator Eagleton, before I ask you some questions, I would like to direct your attention to something you don't talk about much in your testimony; that is, the CFTC itself, the Commission, and the makeup of the Commission.

Assuming for the moment, as I intend to in my question, that we pursue a permanent authorization, I subscribe to a standard that says that whoever is in charge of the operation bears the responsibility for whatever occurs in that operation, though it may be unfair and it may be at times difficult to bear up under that responsibility. If I have control of a ship at sea, for example, and I ignore warnings of a ship ahead and wait until I'm in extremis and we collide and lives are lost, I don't blame the rules of the road. I don't blame the Navy regulations. I don't blame my subordinates. Of course I can, if I want to, blame all those things on others, but I'm not going to get very far.

In today's environment, unfortunately, we all too often, it seems to me, permit people who are in charge to shift the responsibility some place else and say, well, if the rules had just been different, if I just had more money, had things been different, this would never have happened. It's not my fault, in short. I subscribe to the belief that if you accept a position with responsibility, then you have, therefore, to assume that whatever befalls you, good or bad, is yours.

Having said that as an underlying premise for my statement, I'd like to direct your attention to the makeup of the Commission. What would you do with the Commission? What kind of requirements would you impose for appointment, for example, on either the Chair or other Commission members? Would you expand beyond five Commissioners? Would you say specifically in the statute that nominees must have experience with the market, that they've got to have some understanding of what they are regulating? Would you adopt any other kinds of guidelines?

Senator EAGLETON. You have asked me what I would do. I would appoint an activist as Chairman of the CFTC, someone who is

vigorous who wants to pursue the investigatory aspects of that agency. I don't know what standard you could meaningfully write in. I know one thing for sure: I know you cannot write in motivation.

I was in the Senate during the demise of the Legal Services Corporation where we knew the people that were appointed to that Corporation didn't believe in it and wanted to destroy it. I was here during the time that Ann Gorsuch Burford served as Administrator of the Environmental Protection Agency, and we knew that she wanted to destroy the very agency that she headed. So I don't know how you x ray the head of the appointees and determine if this individual is really going to function vigorously, or is this person going to function in a laconic fashion. And you can write all of the requirements you want, and you still cannot write in the will to do your duty and do it vigorously.

Senator KERREY. What would you look to do, though, if you were going to have permanent authorization for the CFTC, and you needed some degree of confidence that the Commission is going to carry out its mandate? By the way, the issue is even more important if you're going to give the agency more money. It's not uncommon to require increased accountability, increased performance, before we provide additional money. Whether it's schools or prisons or law enforcement efforts, that seems to be a common requirement, and I don't think an unreasonable one in regard to the CFTC.

Senator EAGLETON. I would be loathe to rely too heavily on the previous experience with the exchanges because you might end up with the foxes guarding the chicken coop. You might end up that the only people who are applying for the jobs, and qualified, are out of the very exchanges that need the supervision. What's wrong with a retired Federal judge being appointed to it, hypothetically, or a State judge? Benjamin Hooks was a distinguished State judge down in Tennessee before he was appointed to the FCC. Benjamin Hooks wasn't in the radio business or the television business, but he became a very distinguished Commissioner.

I would be reluctant to write in super-experience qualifications with the result being that very intelligent, vigorous lay persons with good common sense were thereby precluded from consideration on the CFTC.

Senator KERREY. What sort of things would you consider if you were making the appointment?

Senator EAGLETON. If I were making the appointment, I would want to be very satisfied—were I the President or such other person that was doing the examination for him—that the individuals being appointed to the agency believed in the kind of work that was being done and believed in the need to pursue their duties with full vigor. Just as I think that President Reagan should have done that in the two agencies I previously mentioned. Self-evidently, he went out of his way to appoint people who didn't believe in the goals of the agencies to which they had been appointed.

By checking someone's background, by talking to people, talking to the individual, you can find a bit out about the individual, about how vigorously that individual is going to pursue his or her duties. But I don't think you can write all this into statute.

Senator KERREY. Thank you.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman, and welcome, Senator Eagleton.

In reviewing your testimony, I noticed that your third point was "Too much regulation in the name of integrity will bog down the markets and will dampen market liquidity." In that same section of your testimony, you indicated that, "Simply put, open outcry * * * cannot be adequately verified and monitored."

Now, in discussions with people representing the markets, they assert over and over that open outcry is very important to the efficiency of the market at this point, that they do not have the technology to eliminate open outcry and go to a fully electronic system; and that if they were compelled to, perhaps we would lose these markets overseas, to Japan, to Hong Kong, wherever.

I'd just be interested in your assessment of where we are with respect to that basic conflict between efficiency and markets that operate competitively and an open outcry system that many would say is an anachronism. What would be your analysis of the tension between those two points of view?

Senator EAGLETON. First of all, item 3, that's not my argument; that's the argument of the industry. Next, I think the Leahy bill gives 3 years to move to this new generation of technology.

Let me analogize another experience of mine here in the Senate. When Senator Howard Baker and I, and others, were working on the first Clean Air Act and Clean Water Act in the early 1970's, the argument we heard was: We can't afford clean air and clean water because we do not have the technology, and if you force technology upon us, we'll all go out of business. That was the argument. You will be forcing us to do things that are not technologically possible.

We went ahead anyway with the Clean Air and Clean Water Acts. We set up the benchmarks of compliance. Once we put them into law, then suddenly new technology burst forth. Suddenly, new technology came out, and what happened? The industries could achieve the standards. Same with the automobile CAFE standards, the automobile gasoline efficiency standards. Ford and General Motors said we can never get to 27.5 miles per gallon, never. I'm from a car State, as Senator Bond knows, the second largest car production State in the Nation. The car makers all came in and they said they never could achieve it, ever. Once we set it into law, all of them but one achieved it. Ford, I think. GM achieved it. Little ol' Chrysler achieved it.

So you pass a law that says open outcry is out in 3 years—I hope that's what your bill is intending to say—and that a fully electronic trading system is in in 3 years, it'll be in in 3 years. Don't worry about it. It's in everywhere else in the world. It'll be in in Chicago and New York in 3 years. Don't worry about it. But the futures people will tell you they can't do it before the 22d century. They'll foot-drag it to death. Don't let them kid you about that. Three years is plenty.

Senator CONRAD. Let me ask another question. When I've been home doing community forums, you can imagine this set of events has disturbed many people in my State. I remember very clearly

being at a community forum and a gentleman standing up in the audience and saying to me, "Senator, I've been reading about this dual trading system, where people on the exchange can trade for their account as well as their customer's account." And the gentleman said to me, "Look," he said, "Human nature being what it is, I doubt very much that somebody is not going to take advantage of me when they're trading for their account and my account. At some point, I'm going to get cheated."

I don't see reference to dual trading in any great degree in your statement. I'm interested in your reaction as to how we ought to treat that.

Senator EAGLETON. You're correct. There is no reference at all to dual trading in my statement. I couldn't cover the waterfront in a short statement, so I was selective. I'm less harsh on dual trading than I am on all of the other items previously stated. There are circumstances in small markets where the trading is light, where dual trading is unavoidable. That's my belief. In the big, big S&P markets and all that kind of stuff, no dual trading is justifiable. Thus, the exchanges and the Congress and the CFTC have to devise a formula that spells out the difference between liquid and illiquid markets in the context only of dual trading. There is some necessity for dual trading in the small markets, I would agree.

Senator CONRAD. Let me conclude by asking, in visiting with people who represent the markets, one of the assertions they make is, look, dual trading abuse with a tightened audit trail is going to be very easy to pick up. If we have a clear record of the transactions, we're going to be able to pick that up. In fact, I had a major customer come and see me yesterday, and he said, frankly, I don't think dual trading is the problem. I depend on those markets, and the people we've decided to have trading for us are the dual traders because they have a better feel for the market.

What would be your reaction to that?

Senator EAGLETON. Yes, some customers do perhaps seek out certain brokers and traders that are dual traders because they're good and they trust them, et cetera. They seek them out because of their knowledge in the market. The concern over dual trading will subside to a large degree, 3 years from now or whenever it is that you have this fully electronic market. Then you will have a reliable audit trail. As I said earlier, perhaps before you came, Senator, the name of the game, in my opinion, as far as these hearings are concerned, is audit trail.

Senator CONRAD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Conrad.

Senator DASCHLE. Mr. Chairman, we have a lot of witnesses. I would just add to those who have already welcomed Senator Eagleton. He has enlightened us and certainly given us a good deal of food for thought. I thank him for doing so.

Senator EAGLETON. Thank you very much, Senator.

The CHAIRMAN. Just about the time you get your jacket off, Tom, we're going to say that this is it. I thank you very, very much for being here. I thank you for the help you have given us. It's good to see you again.

[The prepared statement of Senator Eagleton follows:]

PREPARED STATEMENT OF HON. THOMAS F. EAGLETON, MEMBER, BOARD OF GOVERNORS, CHICAGO MERCANTILE EXCHANGE, FORMER MEMBER OF THE U.S. SENATE, ST. LOUIS, MO

Mr. Chairman, I appreciate your invitation to testify before this committee. I am a former member of the U.S. Senate (1968-1987). After leaving the Senate, I became a member of the Board of Governors of the Chicago Mercantile Exchange. I am still a member of that board.

Insofar as the prevention of misconduct is concerned, the futures exchanges of America operate on three longstanding, interrelated tenets—all, I am sad to say, are false.

(1) *Self-regulation* is the be-all and end-all in assuring the integrity of the futures exchanges.

The futures industry deals in billions and billions of dollars and in millions and millions of transactions. In terms of its fiduciary relationship to the public, it is akin to a bank or a savings and loan. No one today would espouse that the banking or S&L industry be collectively self-regulated. No one can expect any industry at all times to put the public interest ahead of its pocketbook interest. "Greed" and "temptation" are still in Webster's dictionary.

(2) *Benign governmental supervision*. Here's how this one plays in the futures world. Well, if folks won't buy our self-regulation pitch, let's make sure that whatever the Federal Government does falls somewhere between benign and timid.

Fulfilling this prophecy, we have the Commodity Futures Trading Commission—just about as benign and timid as they come. Somehow, Congress designed it to be timid and has kept it timid by inadequate funding and a 3-year reauthorization cycle which keeps the agency in perpetual fear for its own existence.

Perhaps 90 to 95 percent of the CFTC's professional staff time is tied up with processing routine, albeit necessary work. Only 5 to 10 percent of its time—maybe as few as 25 to 35 people—are available to respond to various major policy needs. When something like a Ferruzzi matter breaks, the CFTC is overwhelmed, indeed paralyzed. It cannot respond to other needs. As demonstrated in the FBI Chicago sting, the CFTC is mostly too little and mostly too late.

If the CFTC is to remain as a separate independent agency, it should have full authority to monitor and investigate the futures industry on an active, ongoing basis. The Senate bill moves significantly in that direction. It should have the power to conduct undercover operations and the financial wherewithal to conduct these in the pits where the big action is in play. Both the Senate and House bills provide for this. It is absolutely imperative.

On the other hand, if the CFTC is always to be treated as a regulatory stepchild, then it should be folded into the SEC. This remedy is no panacea, but is certainly better than the status quo.

(3) *Too much regulation in the name of integrity will bog down the markets and will dampen market liquidity.*

There's one old futures guy from New York who loves to say: "OK, you want honest markets, do you? I'll tell you how to have honest markets. Shut 'em all down." To put a reverse spin on this "enlightened" statement, this likable old pro is saying: "If you want active and liquid futures markets, they have to be crooked." Hogwash.

In the era of supertechnology, you can have fully liquid and fully active markets and still offer responsible monitoring and enforcement of the law. Crookedness need not be the indispensable grease of America's futures markets.

The futures exchanges, with their open outcry systems, invite illegalities, self-dealing, and customer abuse. Open outcry may have served a purpose in the era of the quill pen and Ebenezer Scrooge, but it serves absolutely no purpose in the age of GLOBEX, a 24-hour automated international trading system. How can electronic trading be an historic breakthrough in Singapore or Hong Kong, but a dreaded evil in Chicago and New York? Fully electronic trades leave an audit trail that can be verified. Simply put, open outcry in pits of hundreds of shouters, winkers, gesticulators, and body touchers cannot be adequately verified and monitored. The provision of the Senate bill which deals with "next generation audit trail technology" addresses this issue—just so long as open outcry doesn't somehow remain as part of a "next generation."

Mr. Chairman, I agree with the overall thrust of the Senate bill. It's an excellent piece of work that, I am sure, can be successfully blended with the House bill.

I have but one more item to add.

The CFTC should be mandated to establish minimal educational and training standards and monitor the training, education, and continuing education courses of

new and old traders and brokers. A cosmetologist receives more training for his/her trade than do new traders/brokers at our Nation's futures exchanges. As one veteran Merc trader has stated, "We've got a lot of people out there that shouldn't be out there." Amen, brother!

In conclusion, Mr. Chairman, you were absolutely correct when you stated in your October 5, 1989, statement:

"These events [recent scandals] add up to one inescapable conclusion—the system is not working. Rules are being ignored; customers are not being protected. We will not allow the crimes of a few to damage the futures markets. These markets are simply too essential a part of our national economy for us to stand by and allow this to happen. Without the public's trust, the markets can no longer function. They can no longer serve the needs of our country. Today, that trust is damaged."

That statement says it all and makes the work of the committee a matter of urgent importance.

The CHAIRMAN. Before we call our next witness, who is the Chair of the Commodity Futures Trading Commission, Wendy Gramm, I see that our two distinguished colleagues, Senator Dixon and Senator Simon, are here. They both have asked to make statements and I know they are both supposed to be in other committee meetings. So if there is no objection, I would invite them up now. Alan, if you and Paul would come forward. Feel free to go ahead. I appreciate your taking the time to be here because I know you both have tremendous schedules.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM ILLINOIS

Senator DIXON. Thank you very much, Mr. Chairman and members of the committee. I appreciate, on behalf of my colleague, Paul Simon, and this Senator, the opportunity to appear before you today as you look at the reauthorization of the CFTC.

It is our privilege to introduce to you a number of witnesses that you will hear today who are personal friends of ours: Karsten Mahlmann, Chairman of the Board of Directors of the Chicago Board of Trade; Leo Melamed, Special Counsel and Chairman of the Executive Committee of the Chicago Mercantile Exchange; Robert Wilmoth, president of the National Futures Association; Barry Lind, chairman of Lind-Waldock & Co.; and Donald McElmury, Chairman of the Commodity Exchange Committee of the National Grain and Feed Association.

Mr. Chairman, I have a very brief statement that I ask your leave to place in the record of this hearing.

May I very briefly say this to my colleagues and friends on this committee: I would like to make two points. The first is that the futures industry is tremendously important to the economic viability of the city of Chicago and our great State of Illinois. I hope every member of this committee understands that the futures industry in our State employs over 100,000 people, places in the financial institutions of our great State every night \$4 billion, and has imparted a tremendous economic vitality to our State.

The second point I would like to make is that markets are inter-related. Actions which affect the futures industry will also affect our securities markets, our bond markets, and other financial markets. Although I do not now serve on the Agriculture Committee, I had the privilege of serving there before. I hope some of you know that. I have served, since coming to the Senate, on the Committee

on Banking, Housing, and Urban Affairs. After the stock market crash, a good deal of legislation was considered in that committee. Mr. Nick Brady appeared at that time, along with a good many others, suggesting a variety of legislative responses to the stock market crash on that occasion.

We urged at that time our colleagues to not go forward with some of the ideas to set up some kind of a super Federal bureaucracy to overview everything that takes place in the futures industry. We suggested that many of the things that were contemplated at that time were too harsh, and that if the CFTC and the market were able to work together, they could solve most of these problems with our oversight competence as members of that committee, along with the members of the Agriculture Committee. That plan finally went forth, and I would argue that this recent experience that we have had in the marketplace demonstrates that most of the corrections that are necessary have been made.

Finally, I'd want to suggest that everybody, including those that lead that industry, deeply regret, as does my colleague, this Senator, our colleagues in the House from Illinois, the improprieties that have taken place. But I would want to strenuously argue that the law is taking its course. By and large, those people have been found. They have been brought to justice, and the system has worked, just as it works against Members of the Congress or bankers or businessmen or labor union leaders or others who break the law in the performance of their functions in whatever capacity they perform.

So I appreciate my colleagues listening to me today and to my friend and colleague from my State, Paul Simon, and I would suggest that in the final analysis this is an international marketplace. We compete not just with New York, Kansas City, and the Coast, but we compete essentially with London, Tokyo, Singapore, and the whole world. If we take steps that are injurious to our market, I think in the long term it will be a grievous error.

I would urge you to be careful in what you do and to remember that the free marketplace by and large works well, and that a reauthorization of the CFTC with a relatively clean bill ought to be, I think, the standard that the committee ought to seek to ultimately achieve.

I thank my colleagues, and in the absence of the Chair, whoever it be jurisdictional, I ask leave to place this prepared statement in the record.

Senator CONRAD [presiding]. Without objection, we will accept your statement as if given in full, and we very much appreciate, Senator Dixon, your being here.

I think I can speak on behalf of the chairman to say that this committee knows it has a responsibility to react. The events that have occurred are of such significant seriousness that we've got an obligation to respond and react to assure those who are dependent on these markets, that they are fair and effective and honest. At the same time, we understand we can't overreact and regulate these markets out of existence or push them offshore. We are sensitive to the tension that exists here between responding to assure confidence by consumers, and on the other hand not to overreact in a way that would injure these markets and force them overseas.

Senator DIXON. I thank my good friend from North Dakota for that comment. I'm entirely comfortable with his common sense approach to everything and know he'll take that approach to this.

Mr. Chairman, in your absence, I asked the leave of the distinguished chairman of this committee to place a very moving statement in the record. May I have that leave?

The CHAIRMAN [presiding]. And you know that the chairman can hardly wait for the recess to be able to read it.

Senator DIXON. I know that. [Laughter.]

I expect to see you under some tree out in the yard slowly reading it at your leisure.

The CHAIRMAN. In the rain. Of course I will. You have my word on it.

Actually, all joking aside, I will. This is a serious matter. Both you and Senator Simon have talked to me before about it. I would just remind everybody that we must either react in the Congress and react to the issues that have been raised by the sting operations and other events in a way that the American public can have confidence that what we have done is substantive, or we can look for a political way to avoid them. If we do the latter, if we look for a political fix, if we look for a way not to face up to the tough questions, then the American public will lose confidence in the integrity of these markets—rightly or wrongly. We will have done the various exchanges no good whatsoever and we will end up losing these markets overseas.

Futures markets are a unique part of the American enterprise system and one that I am dedicated to keep here. They are extremely important to our country, extremely important to the orderly flow of commodities and money. But they exist only if they have integrity, and that's really the chore for all of us, Republicans, Democrats, and everyone else involved. Maintaining integrity is what this committee is determined to do and do quickly.

[The prepared statement of Senator Dixon follows:]

AGRICULTURE COMMITTEE HEARING
CFTC REAUTHORIZATION
STATEMENT OF SENATOR ALAN J. DIXON
OCTOBER 17, 1989

Mr. Chairman, I am delighted to be here this morning as the Senate Agriculture Committee continues its hearing on the reauthorization of the Commodities Futures Trading Commission. I am quite pleased that the Committee will have the opportunity to hear the comments of some very important individuals from my home state of Illinois. I am sure you will find that their comments and insights will be extremely valuable to the Committee as you attempt to ensure that any actions taken in the course of reauthorizing the CFTC do not undermine the essential role that the futures market plays in our national economy.

I am pleased to introduce to the Committee a group of individuals from Illinois representing a wide range of interests. What they share in common is their involvement in, and reliance on, the Chicago Exchanges. During the course of this hearing the Committee will receive testimony from Karsten "Cash" Mahlmann, Chairman of the Board of Directors of the Chicago Board of Trade; Leo Melamed, Special Counsel and Chairman of the Executive Committee of the Chicago Mercantile Exchange; Robert Wilmouth, President of the National Futures Association; Barry Lind, Chairman of Lind Waldock & Co.; and Donald McElmury, Chairman of the Commodity Exchange Committee of the National Grain and Feed Association.

Mr. Chairman, all of us in this room are deeply concerned over the recent developments which have cast doubt on the integrity of the commodity markets. We are all well aware of the activities which led to the criminal charges and indictments against 46 traders and brokers, as well as the charges and counter-charges embroiled in the July soybean contract incident.

These events, and the practices that have come to light because of them, have lead to increased calls for tougher regulations. I know the Agriculture Committee will soon act on legislation designed to help safeguard the integrity of the futures industry. I sincerely hope that this legislation keeps in mind the need to keep our futures market efficient, and capable of meeting their increasing foreign competition.

Mr. Chairman, financial markets are becoming increasingly international. The Chicago futures markets are the envy of every major money center in the world. They represent an enormous financial asset to the United States. Because of

these factors, and the complexity of the issues involved, there is a good case for caution.

I serve on the Senate Banking Committee. Two years ago we went through the worst stock market crash in our history. At the same time, we had a continuing series of insider trading cases that was undermining the confidence of individual investors in our securities markets.

I am pleased to be able to say that the Banking Committee responded to the real problems uncovered, and that the Committee is continuing to do the kind of work that improves our understanding of our changing financial markets. I am particularly pleased that the Banking Committee was wise enough not to act hastily on broad changes in market regulation which could well have had serious unforeseen consequences for our markets. Instead, the Committee, recognizing the impact that its actions would have on our markets, acted prudently and wisely.

I raise this example, Mr. Chairman, to say that I know the problems the Committee is trying to deal with as it acts on reauthorization legislation. I want you to know that "Cash" Mahlmann, Leo Melamed, and Bob Wilmouth were a lot of help to the Banking Committee as we struggled with the issues related to the Stock Market Crash. I know they will be equally helpful to you in this situation.

I will not attempt to make their case for them here this morning. They can do that much more eloquently and with much more expertise than I can. At this point, I would simply like to reiterate how important I believe these markets are, not just to Illinois, where they have created well over 100,000 jobs, but to our nation in general. I also want to point out something that the Banking Committee became very sensitive to as we worked on how best to respond to the 1987 crash. There must be an awareness that markets are interrelated. Actions which affect the futures industry will also affect our securities markets, our bond markets, and other financial markets. That is another reason for caution, Mr. Chairman.

There is a lot at stake here. There is a lot at stake for the futures markets, but there is just as much at stake for all of our financial markets.

I have some concerns about the legislation now before the Committee. The Agriculture Committee, however, has always had a reputation for producing legislation that was soundly based on the evidence. You will be hearing from an extremely good group of Illinois witnesses this morning. I know they will be of great assistance to you and your Committee as you attempt to complete final committee action on the bill. I also look forward to continuing to work with you and your Committee, Mr. Chairman. I want you to know that there is no more important issue in this Congress for me than this one.

The CHAIRMAN. Senator Simon, I will yield to you. We will be talking to both of you, of course, because both of you have an intimate knowledge of these markets. I want to emphasize to all Senators that whatever we have heard in our town meetings back home—in the Dakotas, Nebraska, Missouri, Vermont or anywhere else—this year when this was a front-page item, is nothing compared to what we will hear, and rightly so, if we assume for these markets that things can simply be business as usual.

Senator Simon.

STATEMENT OF HON. PAUL SIMON, A U.S. SENATOR FROM ILLINOIS

Senator SIMON. Thank you, Mr. Chairman.

I simply want to underscore everything Senator Dixon said about the need for a bill that protects the users of the commodities exchanges and that also strengthens the exchanges' competitive edge over foreign futures markets.

No one is suggesting that there should just be business as usual. I think the question is: Did the people who are going to be witnesses here—Karsten "Cash" Mahlmann, who is the Chairman of the Chicago Board of Trade; Leo Melamed, who is the Chairman of the Executive Committee of the Chicago Mercantile Exchange—just sit back and say that they want this bill to allow them to conduct business as usual?

They clearly did not. They are people—and my colleague and I have worked with them for some time—they are people of integrity who, when problems arose, said we have to move vigorously to solve them. And they did just that.

Again, I would just underscore that I hope the committee isn't so eager just to do something that we do the wrong thing. I think that's the other thing that we have to be very careful about. We have to protect farmers in Illinois and North Dakota and Nebraska and South Dakota and Missouri and Vermont. I don't know how many grain farmers there are in Vermont but—

The CHAIRMAN. Both of them are watching with great interest. [Laughter.]

Senator SIMON. We also have to make sure that we don't do something that will cause users of the Nation's futures markets to take their business to Japan, or England, or France. We can and must reach both these goals in the bill.

We must move with some prudence, and I would simply urge the committee to work with the exchanges and with others who are in positions of responsibility so that we emerge with rules that are tighter, that protect the public better, but that also don't shift our markets overseas. The danger is in passing a bill that doesn't strike that balance.

Mr. Chairman, I would urge you and the committee to be very, very careful.

As Senator Dixon has said, the futures markets provides 100,000 to 110,000 jobs in our State. That's a lot of jobs.

But more than that, what we do here will affect what happens in North Dakota to the price of wheat and soybeans. If we don't do our job properly farmers won't be protected, market users won't be

protected and billions of dollars worth of economic activity will flow away from this country.

If I could just steal a line, also, from Senator Eagleton when he said here that one of the big problems is the staff of the CFTC. We have to be careful, if we're unhappy with certain personnel, that we don't overreact with legislation and ultimately do harm. I think there is a danger of doing that here.

I have nothing further to say, Mr. Chairman, but I know after you read Senator Dixon's remarks you will be fully persuaded as to our position.

The CHAIRMAN. Thank you very much, Senator Simon and Senator Dixon. As I said, you have spent time with each member. I know that both of you are supposed to be in other committees. I appreciate your taking all this time to come over here. Good to see you both. Thank you.

Senator SIMON. Thank you.

Senator DIXON. I thank the Chair and the committee.

The CHAIRMAN. Chairman Gramm, please join us up here.

Madam Chair, go ahead.

STATEMENT OF WENDY L. GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC; ACCOMPANIED BY DONALD L. TENDICK, ACTING EXECUTIVE DIRECTOR; JOHN R. MIELKE, DIRECTOR OF SURVEILLANCE; ALAN L. SEIFERT, DEPUTY DIRECTOR IN THE DIVISION OF TRADING AND MARKETS; AND PAT G. NICOLETTE, DEPUTY GENERAL COUNSEL

Dr. GRAMM. Mr. Chairman, let me introduce the members of my staff.

INTRODUCTIONS

To my left is Donald L. Tendick, our Acting Executive Director, who knows our budget back and forth; John R. Mielke is our Director of Surveillance; and we have here on my right Alan L. Seifert, Deputy Director in the Division of Trading and Markets; and Pat G. Nicolette, who is our Deputy General Counsel. Both Pat Nicolette and Alan Seifert have provided the committee staff with technical help on the bill and probably know this bill quite well.

REPORT ON THE VOLATILE MARKET ACTIVITY

Before I start, I would like to take just a minute to report on the volatile market activity that occurred in stock-index futures and the stock market last Friday, and then through the morning hour on Monday, October 16, including the Sunday evening trading in Treasury bond futures market at the Chicago Board of Trade. I would like to report that there was more planned coordination and communication between regulators as a result of the procedural framework established by the Presidential Working Group. Commission staff and I kept in close touch with the exchanges, clearing associations, our counterparts in the regulatory agencies, including the Treasury and the Council of Economic Advisers.

The coordinated circuit breakers, with the related shock absorbers and sidecars that were established by the working group last year appeared to function smoothly. The new communications

system that we call "Hoot and Holler" that was the communication link between the exchanges and the regulators to share breaking market information also functioned well. I've many comments about the value of that particular system.

I'm pleased to report that financial integrity in the futures market remained intact. There were intra-day margin calls that were made and collected at the usual times and without incident, despite the very heavy volume and significant price moves. There were no financial problems in the futures markets. Because of arrangements put in place as a result of the working group recommendations, there was increased coordination in the clearing and settlement area as well, and that was of particular interest to the working group after the 1987 events. And I'd report that that worked well here.

REFORMS WORK AS DESIGNED

The reforms instituted after the 1987 market break, including the circuit breakers, coordinated communication, and the clarified settlement agreements between the clearing organizations and the settlement banks, appeared to work as designed. The Commission has already begun an analysis of the markets during that market period, and we will make that available as soon as we can. As you know, this will engender a number of other studies to look in detail as to what happened and the trading that happened on those days.

COMMISSION'S VIEWS ON S. 1729

Mr. Chairman, I am submitting for the record a prepared statement describing the Commission's views on S. 1729, the Futures Trading Practices Act of 1989. Today, I will just highlight the Commission's views on the legislation.

Let me reiterate the Commission's commitment to ensuring the integrity of our Nation's futures markets and maintaining the public's confidence in those markets. That confidence factor is critically important to the continued growth and international competitiveness of the U.S. futures industry and to everyone who depends upon it.

WE SUPPORT THE BILL'S GOALS AND ENDORSE MOST OF ITS SPECIFIC PROVISIONS.

Accordingly, we appreciate the efforts of you, Mr. Chairman, as well as Senators Lugar and Kerrey, cosponsors, in introducing a bill that is strong and addresses many of the difficult issues that have arisen in recent months. We support the bill's goals and endorse most of its specific provisions.

COMMODITY EXCHANGE ACT

We also appreciate your favorable consideration of our legislative recommendations for amendments to the Commodity Exchange Act. As explained in our previous submissions to the committee, these amendments will enhance international law enforcement cooperation, provide additional customer protections in bringing private damage actions against fraudulent operators, increase flexibil-

ity in the imposition of civil monetary penalties and require the registration of floor traders.

STUDY ON DUAL TRADING

I would also like to take this opportunity, Mr. Chairman, to apprise you that the Commission is completing its empirical study on dual trading that was initiated earlier this year, and to briefly summarize its findings. The study measures the extent of dual trading and performs certain statistical analyses concerning the possible benefits of dual trading. In summary, the vast majority of dual traders are highly specialized as either customer traders or personal traders. Further, tests of relative performance do not indicate that dual traders as a group are superior traders or brokers compared to nondual traders. The tests indicate that dual and nondual traders are similar in terms of the trade executions and liquidity they provide to the market. Our results also indicate that dual traders do not trade more intensively in either low volume markets or more distant trading months.

Based on these results and considering the problems associated with dual trading, the Commission is prepared to begin rulemaking, to write rules, to restrict dual trading subject to certain exceptions. Obviously, these exceptions and details of implementation will be described in the forthcoming prepared rules and publication requesting public comment. The Commission will also be providing a more detailed briefing to the public, to Congress, its staff, and to interested people when we release the study. We will be releasing the study in a week or two. This initiative is intended to address the concerns that motivated the proposed legislation to limit dual trading included in both the Senate and House bills.

HIGHLIGHT A FEW PROVISIONS OF S. 1729 AND SOME SUGGESTIONS FOR CHANGE

I would like to now highlight a few provisions of S. 1729 and some suggestions for change. We believe the provisions for enhanced audit trail and improved trade surveillance and disciplinary systems at the exchanges will be valuable additions to the Commission's existing oversight program. As you know, an improved audit trail has been a long-held Commission goal. We do, however, have some concerns about legislatively mandating technology in advance of evidence that the mechanisms are technologically feasible, practicable, or free of potentially more troublesome attributes. We also believe that the standard required for audit trail and market sequencing improvements should be one of technological practicability instead of technological feasibility. Substituting the words "practicable" for "feasible" in this standard will go a long way to providing needed flexibility for the exchanges and the Commission.

We understand the bill considerably broadens the reach of the antifraud provisions of section 4b of the act. Under existing law, section 4b applies to acts or omissions where there is direct harm to the customer. Among other things, proposed section 4b(E) appears to permit persons with no customer or other relationship with the wrongdoer to bring suit. Based upon our experience using

section 4b to combat fraud, it is our belief that this increased prospect of liability could have a significant and perhaps unintended impact upon the operations of brokerage firms and other industry professionals.

The Commission supports most of S. 1729's provisions which would strengthen and expand penalties and increase the range of law enforcement and customer remedies available under the act. However, we believe that further clarification is necessary. Is it the intent of Congress, for example, to create *felonies* for missing reporting deadlines or for violations of minor book and recordkeeping requirements?

I should also bring to your attention, Mr. Chairman, that in regard to empowering the Commission to order customer restitution in administrative cases, the Commission supports customer restitution as a remedy. However, a majority of the Commission believes that current law provides sufficient recourse for customers to obtain reimbursement of losses—when funds are available. In many cases, funds are not available. The Commission can and does already seek disgorgement of funds for customers in Federal injunctive actions under the act's current provisions. Furthermore, under the private right of action, customers can go to Federal courts to seek restitution. Customers can also seek restitution in exchange or NFA arbitration forum.

Finally, the Commission has, as you know, a unique reparations program, unlike other independent enforcement agencies, that allows customers to obtain damages. Thus, a majority of the Commission believes that additional authority is not necessary and could serve instead to raise expectations or to detract from these other avenues.

In conclusion, Mr. Chairman, despite a few concerns, we believe S. 1729 is a good bill which provides the Commission with the resources necessary to enhance its regulatory authority and achieve desired improvements in the system. We look forward to working with the committee further in the weeks ahead to develop a bill that ensures market integrity without compromising the flexibility needed to respond to a changing marketplace.

The CHAIRMAN. I notice that in your testimony, where you state:

Based on these results and concerning the problems associated with dual trading, the Commission is prepared to write rules to restrict dual trading subject to certain exceptions. These exceptions and details of implementation will be described in the forthcoming proposed rules and publication requesting public comment.

Now, is that an approach similar to what is in the Senate bill?

Dr. GRAMM. Obviously, the details of the rulemaking have not been done yet, but, yes, the approach that we are thinking about would be consistent with what is in the bill.

The CHAIRMAN. Going back to last Friday's market problems, are you satisfied with the level of intermarket coordination that occurred and what you have seen so far?

Dr. GRAMM. Yes, I am.

The CHAIRMAN. Has the storm passed for these markets, or are we facing some heavy volatility in days ahead? Every broker in the country is weighing your answer.

Dr. GRAMM. As you know, I make no market predictions.

The CHAIRMAN. Are there any automatic signs of heavy volatility that you see?

Dr. GRAMM. Not at this point.

The CHAIRMAN. Now, in S. 1729, we expand the CFTC's authority to charge fees against industry participants, those who benefit from the services and the activities of the CFTC. We intend, as you know, to recoup through this provision about the amount of the increases in the CFTC budget that will be authorized under this bill. Those increases, of course, are significant.

Based on what you have seen of the legislation, how much money per year do you think that S. 1729 would enable the CFTC to collect through the service fees?

Dr. GRAMM. Well, based on the specific authorities that were mentioned in S. 1729 and providing for, say, increased fees to cover increased floor surveillance, I think we estimated that would come to about \$4.9 million per year. Is that correct?

Mr. TENDICK. In addition to what we are collecting now.

Dr. GRAMM. In addition to the—

The CHAIRMAN. It would be about \$4.9 million in addition to what you are already collecting in service fees?

Dr. GRAMM. That is right.

The CHAIRMAN. Thank you. We also, in S. 1729, require the exchanges to implement new audit trail technologies in 3 years which are able to record trade times and on a form that cannot be altered by the trader. Once it is recorded, that is it. No one can alter it. This concern, of course, arises from the allegations in the recent Chicago indictments that some traders made fraudulent entries on trading cards or on their manual audit trail records.

Now, do you agree with us that anything less than an "independent, precise, and complete" audit trail is not sufficient to police the trading pits against abuses?

Dr. GRAMM. Well, I have looked at the GAO report as well on this, and I would agree that more precise timing and independent or unable-to-be-altered trading cards can increase our ability to both deter and detect some kinds of trading abuses.

But there are other kinds of trading abuses as well that the improvement would not necessarily catch, for example, some of the kinds of violations that were occurring as charged in part of the indictments.

The CHAIRMAN. Let me make sure I understand your answer. Are you saying that you can do your enforcement without independent, precise, and complete audit trails?

Dr. GRAMM. No, I think—

The CHAIRMAN. I mean, you have different kinds of enforcement—

Dr. GRAMM. Right.

The CHAIRMAN [continuing]. But are you better off with or without independent, precise, and complete audit trails?

Dr. GRAMM. As you know, the Commission is long committed to improving audit trails and getting more precise information. With respect to independence, our recent efforts in rulemaking to remove the trading cards from the hands of traders would achieve some results similar to independence—that is—unable to be altered.

The CHAIRMAN. My last question is that 2 weeks ago, the CFTC rejected, by a 3-to-2 vote, a proposal which we had contained in S. 1729 which would allow the CFTC administrative law judges to require defendants found to have defrauded customers to pay restitution to those customers.

Your argument, as I read it and as I understand it, is that existing remedies for customer recovery are good enough and that this new one is not needed. However, according to the figures cited by Commissioner Fowler West at your meeting, the total estimated customer losses in CFTC administrative, injunction, and other cases, were more than \$80 million in fiscal 1988 alone, while the total fines, disgorgements and restitutions were \$13.7 million, a small fraction of that \$80 million.

With that kind of a record, how in good conscience can you block any proposal aimed at helping customers recover their losses from fraudulent operators on the grounds that current avenues of restitution are good enough? I mean, are you not there to protect the people? You are a public body, not an industry body. How can you say that, if the losses are \$80 million, we are doing well enough if we recover only \$13.7 million?

Dr. GRAMM. Let me clarify my comments. The Commission supports getting customer restitution, where there are funds to be gotten, and I would say that in many cases——

The CHAIRMAN. You would never know it by the vote.

Dr. GRAMM [continuing]. In many cases, when we have gone in, when customers have lost money, there is not money to be had from the firm that has been doing the defrauding, and while the Commission supports getting customer restitution, the Commission feels that there are these other four avenues and we would not want to deter or detract or to raise customer expectations and detract from these other avenues that are available. The Commission does seek disgorgement of customer funds in Federal District Court as well. When the funds are available, we seek that as a remedy.

The CHAIRMAN. But your 3-to-2 vote does not indicate that. You say that we all want everybody to recover, but do not ask us to help. We will block your recovery, so we do not hold out false hopes. I do not understand that at all.

Dr. GRAMM. Well, I think that the 3-to-2 vote indicates that it was a close Commission decision and, as I indicated earlier, all members of the Commission support customer restitution as a remedy.

The CHAIRMAN. Well, do you——

Dr. GRAMM. It was felt that there were these other avenues such as the Commission's reparations program, as well as the private right of action, as well as the Commission seeking the injunctive action in Federal court, where there are funds available.

The CHAIRMAN. We have a proposal in S. 1729 which would allow the CFTC administrative law judges to require defendants found to have defrauded customers to pay restitution to those customers. Are you in favor of that provision or not?

Dr. GRAMM. The majority of the Commission just feels that that is not necessary——

The CHAIRMAN. I understand what the vote was. Are you in favor of that provision or not?

Dr. GRAMM. I voted with the majority on that.

The CHAIRMAN. Mrs. Gramm, your vote is a matter of record. Are you in favor of that provision in S. 1729 or not?

Dr. GRAMM. No, I am not.

The CHAIRMAN. Thank you.

Senator Lugar.

Senator LUGAR. Mr. Chairman, I ask unanimous consent that a statement I would have offered at the beginning of the hearing be made a part of the record, and I apologize that another meeting made it impossible for me to be here at the beginning.¹

In order to expedite the hearing I have no questions to ask at this point.

The CHAIRMAN. Thank you.

We will go to Senators Kerrey, Bond, Conrad, Daschle, and Fowler.

Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman.

Chairman Gramm, I would like to continue with the question that Senator Leahy asked. As I understood it, the proposed rule did not require that restitution be made in every instance, it simply gave the administrative law judge the option of ordering restitution when money was available. Further, it directed the CFTC to simply take customer losses into account.

I do not find that inconsistent at all with your stated objective of making sure that other avenues were used. Certainly, if money was available and the judge was willing to take losses into account, I do not understand at all why you oppose that particular change in your authority.

Dr. GRAMM. We do, as a matter of Commission policy, take customer losses into account and also take into account whether or not a firm has made restitution to customers.

Senator KERREY. But the administrative law judge currently cannot take customer losses into account and currently does not have the option of ordering restitution, if money is available.

Dr. GRAMM. That is correct.

Senator KERREY. Now, I just leave it at that. I wanted to align myself with the chairman in feeling that this is a very reasonable thing, not anything that would hamper the CFTC. I really did not want to stir up additional comment, because I think you have answered the question and offered reasons why you do not think the change should be made.

Let me talk a little bit about undercover investigations. You and I have had previous discussions about it. You may be aware that Agriculture Secretary Yeutter, after the last hearing that we had, made statements to the effect that the FBI sting operation showed that the exchanges and the Commission did not find all the wrongdoing and that giving the CFTC authority to conduct undercover investigations would be a step toward increasing confidence and improving oversight.

You seem to believe that that is not necessary, is that true?

¹ The prepared statement of Senator Lugar can be found on p. 2.

Dr. GRAMM. I believe that the current situation, with the FBI having the authority, is sufficient. In fact the kind of coordination which has occurred with the undercover operation, the sting operation that we all know about and that has been publicized, is an example of how government law enforcement officials can coordinate and, indeed, in a very effective way, to bring a case——

Senator KERREY. Let me describe to you the coordination as I see it, Madam Chairman, and you tell me if you think I am right or wrong. Customers were not getting their complaints addressed, they brought a number of complaints to the U.S. Attorney, Anton Valukas, who began an investigation on his own, and when the investigation was pretty well ongoing, he notified you that something was about to happen.

Dr. GRAMM. No, that is not. We participated in that investigation from the beginning.

Senator KERREY. You self-generated the investigation and went to Anton Valukas and said we have some problems and we need an undercover investigation?

Dr. GRAMM. I did not say that we self-generated it. As a matter of fact, the issue of exactly the beginnings of the investigation is something that, as you know, the Justice Department has kept confidential; for various reasons, it is something that is not disclosed, but we have——

Senator KERREY. Well, I am growing increasingly uncomfortable with the various reasons, I must tell you, because this is a very key point in our trying to determine whether or not to give you this authority. At some point we are going to either have to have those various reasons or people like me will simply conclude, and I believe there is sufficient reason to conclude it, that the CFTC was not going to pursue an investigation, that without the U.S. Attorney's Office following through on its own, this investigation would not have occurred at all.

Dr. GRAMM. I would just——

Senator KERREY. That is what people like me will conclude, unless those various reasons are supplied to us, because it seems to me that——

Dr. GRAMM. Excuse me, but I would like to put in the record of the hearing a letter from the U.S. Attorney, the only one that actually came early on.² He was thanking me for our participation in that undercover operation and indicated that we were participating since its inception. That letter came to me unsolicited, I think it was sometime in February or March, earlier this year.

Again, the details of who started what, or when, are details that, as you know, the Justice Department has kept confidential, and I have let them know of the fact that you are very interested in just exactly those issues, given your concern of oversight over our Commission.

Senator KERREY. I have seen the letter, because you provided it in a previous hearing, but I am just telling you that I have reached the conclusion that, had Anton Valukas not generated that investigation on his own, no investigation would have occurred. I have

² See p. 68 for the letter of Anton R. Valukas, United States Attorney.

reached that conclusion. That you cooperated, that you did not obstruct the investigation is a secondary matter to me. I have concluded that the generation of the investigation occurred as a consequence of complaints filed with the U.S. Attorney's Office, not as a consequence of complaints filed with the CFTC.

Dr. GRAMM. I would like, also, to let you know about our commitment to undercover operations as a general matter. I am very strongly in favor of having undercover operations occur. The kind of cooperation with the FBI not only existed in the past, but is continuing and will continue in the future. I have had several conversations with Judge Sessions and his staff, so you can be assured that that kind of coordination and cooperation will continue.

Senator KERREY. You are quoted in the Chicago Tribune, on the 3d of August, in response to a question about this kind of undercover operation, as saying that "The FBI basically has the authority to break a lot of laws in order to do the undercover operation, and we want to leave the undercover authority with the folks who do that." Is that an accurate description of your feelings toward the FBI and their authority?

Dr. GRAMM. Yes, I think that they have the expertise, as well as a lot of experience now, over the last 20 years, in the actual conduct and the kinds of problems that occur with complicated undercover-type operations, and I would, if you are interested in that, I would be happy to have the FBI come up and explain those aspects to you.

They do have the authority, for example, to bypass a lot of the laws, the laws, for example, that govern government employees with respect to contracting, with respect to false identities for trading on exchanges, to keeping the funds from the trades, all those, you might say, the more technical details of being undercover.

Obviously, there has to be coordination and cooperation and real close contact among the agents and the CFTC, because of the expertise, the knowledge of what makes a trading violation, where the customer is abused and how and what kinds of records must be used to build the best case, and that is the kind of effort and support in staffing that we provide and will continue to provide in the future—

Senator KERREY. My discomfiture is a consequence of your observation (a) that the FBI has the authority to break a lot of laws, and that (b) you think, if that is your observation, that that is the preferred agency, then, to carry out these undercover operations.

Dr. GRAMM. Perhaps a philosophical point, that in my view the operation that occurred in the past is a good example of how agencies can work together in something very complicated, very innovative for financial markets and come to some real conclusions. We have 46 indictments. Now, I know that the process is still ongoing, and let me not prejudice it, but still we come to some very vigorous law enforcement conclusions there and, again, the investigation is still ongoing.

We support that. My view is that if things work well, unless there is something that needs to be changed, that we do not seek the authority to change. That is, again, the reason why, from my previous vote that concerns you, if there are other avenues producing results, I do not see a need for that particular change. That is

very different from saying that I oppose doing undercover operations at all. That is wrong.

I think that undercover operations may well be the only way you can catch some kinds of violations on the trading floors, and certainly may be the most cost-effective way to do so.

Senator KERREY. I am sure, Madam Chair, that you have read and heard in my statements to Senator Eagleton that I believe that you should hold responsible those who are in charge for whatever happens under their watch, and I do not want this to be personal, but I have questions about whether the Commission itself has done all that it could.

I would like to ascertain, for example, if your job is a full-time job. Do you work all of your hours at the CFTC?

Dr. GRAMM. It is more than a full-time job.

Senator KERREY. Do you work any additional hours for this administration in other policy areas?

Dr. GRAMM. In other policy areas? No.

Senator KERREY. You spend no time in your working week doing other policy considerations for this administration?

Dr. GRAMM. No. I spend all my time on this job. From time to time, other people may ask me about issues that I dealt with earlier. But no time, no significant time is spent on other than my job.

Senator KERREY. Let me give you one more time to answer this question, Madam Chair. When they ask you questions, do you say to them, "I don't have time to answer that," or do you allocate some of your time to attempt to answer other domestic policy questions that face the administration?

Dr. GRAMM. I am not aware of other domestic policy issues that have come up to me to spend any significant time on.

Senator KERREY. I did not say "significant time," Madam Chair. I asked you any time, and you said none, and now you are qualifying that with "significant." Let me be the judge of whether it is significant or not. Do you spend any of your time on other policy matters?

Dr. GRAMM. I think I might spend a few minutes over the weeks if someone asks me about an issue that I might have dealt with back when I was at OMB, but just to refresh their memory. Again, it might be 5 minutes of a telephone call—with a question, such as, do you remember what occurred with respect to a statistical policy issue or something like that.

Senator KERREY. No more than that, you would never leave the office to go to OMB, leave the office to participate in other policy matters, other than your work at the CFTC?

Dr. GRAMM. Certainly not on anything other than financial markets and other financial policy issues.

Senator KERREY. Thank you.

The CHAIRMAN. Thank you.

Senator Bond.

Senator BOND. Madam Chairman, maybe it would helpful to know how many hours a week you normally spend on the work of the CFTC?

Dr. GRAMM. How many hours per week? Let me see, I normally get in around 8, more recently 7:30 in the morning when the mar-

kets are busy, leaving around 7 in the evening. This weekend, we had a meeting on Sunday and so we were in all weekend.

Senator BOND. Would it be fair to say 60 hours-plus?

Dr. GRAMM. At least. At least.

Senator BOND. That is certainly not insignificant and I have to say very great dedication to the work.

There have been some other questions raised about the activity of the Commission and whether it is a sleeping giant or sleeping pygmy or sleeping beauty. Would you like to comment on the attitude and the mission, as you see the CFTC under your leadership?

Dr. GRAMM. I would be happy to. I would like to say that I prefer to be a sleeping beauty than a sleeping pygmy. I think it is important to remember that the Commission is very active. Not everything necessarily makes the news, but we do an awful lot of our activity in a way that is quiet and does not make the news. Our rule enforcement reviews. We do our ongoing market surveillance well in advance of anything that might become public, and many things do not become public.

In the past year and a half, for example, that I have been there, the Commission has responded to the events of the stock market crash, and I think very responsibly so. I think the events after 1987 indicated that the futures markets and, indeed, the regulatory structures in place there were strong and, indeed, a lot stronger than expected, given the volatility back in 1987. We did not have any financial losses due to failure of firms back even in 1987. Obviously with the investigation that occurred, we have had strong Commission action and involvement in that investigation, cooperating with the law enforcement agencies.

We have brought other very significant cases over the last months in sales practice fraud, for example, that are dealing with very large firms. As a matter of fact, the Director of the Division of Enforcement received a Presidential award, a merit award this past year that I recommended him for and that he was given. It was given to one-half of 1 percent of the members of the Senior Executive Service. We have been very vigorous in the way of law enforcement, cooperative law enforcement, not only at the FBI highly publicized levels, but also on our own and with the State and local officials. We also have made great strides in international cooperation and cooperation with international law enforcement efforts, as well as with other international regulators. We have some far-reaching memorandum of understanding to share information with international regulators.

I think that while people may disagree on the events regarding soybeans, frankly, we monitored those markets over the years, much of which was not made public, and averted what could have been a very disorderly situation there. I think, in all respects, this Commission has been, indeed, very vigorous. We responded to what we found as a result of the undercover operation and indictments. As I kept saying, one of the purposes of an undercover investigation is to determine what changes and what reforms might be made and need to be made and, indeed, we have moved forward on a number of reforms, not the least of which is a dual trading study, as well as rulemakings in response to what we found over the past year and a half.

Senator BOND. Madam Chairman, I know it is still too early, as Senator Eagleton and I discussed, to evaluate all the things that happened last Friday and yesterday, but I would say that, even though the fall was not as precipitous and there were not the other factors involved as there were in 1987, at least on the surface it appears that definite progress has been made. I would certainly compliment you and the working group and the exchanges for adopting reforms and improvements in procedures which lead to many of the actions taken. We are obviously going to be having more hearings on that in this committee and probably also the Banking Committee will get to hear discussions again.

Dr. GRAMM. I forgot to mention that as well.

Senator BOND. All right. Just a couple of questions.

You have indicated in your testimony that there should be some exceptions to restricting dual trading. How would you deal with liquidity problems that the bill might raise if a strict ban on dual trading was applied on smaller exchanges?

Dr. GRAMM. Basically, Senator, the details of the ban and what kinds of exceptions, say, for customers who would want to use a dual trader or exceptions for new contracts, or whatever, are details that the Commission has yet to address, but they will certainly be addressed during the rulemaking process.

Senator BOND. Do you have any concerns on a broader scale that some of the provisions in the bill might result in U.S. markets, particularly the Chicago markets, losing their edge internationally, with the result that we would see some more of this particular type of financial transaction moving overseas and, if so, which provisions and what could be done to alleviate the problem?

Dr. GRAMM. I think, as I indicated in my testimony, there are several areas of concern. One is the concern about mandating a technology for which there might be some other more serious problem or that might not be technologically feasible. As you know, the Commission has been very active in monitoring computerization and innovations like GLOBEX.

Again, there are not many computerized trading systems, not many around the world, and there are not many that have large volumes, either. And there could be other problems that we need to be very careful about, such as computer security and financial integrity. So, I have some concerns about mandating something that may have other problems or may not be practicable.

There are some other provisions in here that could create additional concerns about liability for some of the big FCM's, for example, that would have a greater effect on the FCM group, the large institutions, rather than the exchanges. So, there are some things that would affect exchanges and the costs there, but also some that affect other institutions as well.

Senator BOND. Thank you very much, Madam Chairman.

Senator CONRAD [presiding]. Thank you, Senator Bond.

Chairman Gramm, if the FBI investigation turned up some 46 indictments, approximately 19 of those were traders in the soybean pit. Could you tell me if, to your knowledge, any of those traders are still actively trading?

Dr. GRAMM. I believe that in the soybean pit, there are some who may be trading, but there are none trading for customers. I will have to get that information and provide that for you.

Senator CONRAD. Do you have any ballpark estimate of how many of those that are under indictment are still trading?

Dr. GRAMM. Of the 46 traders, it is my understanding that there are about—and I will have to get the correct figures for you—there are about 17 that may be trading, and I believe on the Chicago Board of Trade that none of those are trading for any customers.

Senator CONRAD. As I understand it, your indication is, of the 46 who were indicted, some 17 are still trading, is that approximately correct?

Dr. GRAMM. I believe so.

Senator CONRAD. Does that raise questions in your mind as to the enforcement mechanism of the exchanges?

Dr. GRAMM. As you know, the traders are indicted and they are going through the process and they are——

Senator CONRAD. Have we not had 46 indictments and are they not——

Dr. GRAMM. That is right, 46 indictments, and of those 8 are settlements, and I believe that some firms have voluntarily kept some of the traders from trading.

Senator CONRAD. I am a bit confused here by your answer, because I indicated that 46 were indicted——

Dr. GRAMM. That is right.

Senator CONRAD [continuing]. And you indicated that 17 are still trading. Then you indicated they were not yet indicted, that they were going through the process.

Dr. GRAMM. No, I am sorry, they are indicted but they have not been tried or found guilty yet.

Senator CONRAD. My question is, if people have been indicted and are still trading, does that not raise some questions about the enforcement mechanism of the exchanges, the policing mechanism? Are you comfortable with the fact that 17 of 46 who were indicted are still trading, according to your numbers?

Dr. GRAMM. I do have some concerns about that and have spoken to the exchanges about that issue. It is my understanding that, of the people who are trading, that there are some who are not handling any customer accounts at all, just trading for themselves. But I do believe there are maybe some 11 who are still trading and we do have some concerns about that.

Senator CONRAD. There are 11 who are still trading?

Dr. GRAMM. Trading for customers, including——

Senator CONRAD. Who were indicted?

Dr. GRAMM. Who have been indicted but not yet found guilty.

Senator CONRAD. Well, let me ask you, that strikes me as raising serious questions about the process that we have here; of the enforcement process that we have. If you share that concern, as I hear you saying that you do, what have you done about the fact that 11 of the 46 who are indicted are still trading for accounts other than their own?

Dr. GRAMM. Well, we have looked just at what our authorities are, but you also recognize that these are traders that are indicted but they are still going through the process of——

Senator CONRAD. Still going through the legal process?

Dr. GRAMM. Right.

Senator CONRAD. I understand that, but what I am asking you is if you are concerned about 11 of 46 who are indicted still trading for accounts other than their own, trading for public accounts, my question is what have you and what has the CFTC done about it?

Dr. GRAMM. Well, the Commission and I have researched what avenues there are with respect to those who may still be trading, but, again, it is something that the Commission has discussed, we have balanced the concern about trading against the individual rights of the traders who are innocent until proven guilty.

Senator CONRAD. Well, what about the public rights of those who ought to have confidence, ought to have ability to have confidence in the markets? I must say I am finding these answers disturbing.

If we have folks who have been indicted for abuse of their trust and 11 of the 46 are still trading for public accounts, 17 are still trading, what does that do for confidence in these markets?

Dr. GRAMM. Again, the—

Senator CONRAD. What do we say to the farmers out there who are dependent on these markets to get a fair deal and they have 11 people still trading for their accounts who are under indictment?

Dr. GRAMM. First of all, I do not think any are trading on the Chicago Board of Trade, there are none that are trading for customer accounts at all. Again, you might raise that with the exchanges. I did raise that with the exchanges and, again, it is an issue of people being innocent until proven guilty. It is a concern at the Commission about their registration and the Commission did consider whether or not we should move forward in pulling back those registrations, but the Commission—

Senator CONRAD. You are the regulator, and if you have 46 people that are indicted and, according to your testimony, as I understood it—perhaps I misunderstood—11 of those are still trading for accounts other than their own, and my question to you is, if you are concerned about it, you indicated you are concerned, what have you and the Commission done, as the regulator, to assure the public that they are dealing with honest folks?

Dr. GRAMM. Well, we have done a lot of things to assure the public—

Senator CONRAD. With respect to these 11?

Dr. GRAMM. With respect to those 11, I think that the U.S. Attorney also has been quite clear that they are innocent until proven guilty. However, the Commission has raised that concern with the exchanges and at this point has not taken action in that particular area.

Senator CONRAD. Does that leave you with some concern about the process here? I mean if people are under indictment for cheating customers and they are still out there trading, does that not raise some concern about what kind of a process we have here? I mean should not they be suspended, should not something happen, should not you, the regulator, be involved in assuring that folks out there as customers are getting an honest shake?

Dr. GRAMM. Indeed, again, that is something that the Commission has considered in the past. The U.S. Attorney, as well as we, are concerned about bringing overlapping cases, but again, with re-

spect to that particular registration issue, is something the Commission has considered and has——

Senator CONRAD. Has done nothing.

Dr. GRAMM [continuing]. Has considered and decided earlier on that we would not take action at that time.

Senator CONRAD. So you have considered it and done nothing?

Dr. GRAMM. Considered, again, against moving forward in a legal action that would have some questionable——

Senator CONRAD. I would just say again, Mrs. Chairman, I do not think that is very confidence-building for those who are out there who are relying on these markets.

Dr. GRAMM. It would involve questionable use of our authority to be able to pull the registration, and again, bearing in mind that they are innocent until proven guilty, basically.

The CHAIRMAN [presiding]. Dr. Gramm, could the exchanges themselves suspend these 11?

Dr. GRAMM. The exchanges themselves, as I understand, have taken some voluntary actions——

The CHAIRMAN. Could they suspend them? Whether they have or not, could they?

Dr. GRAMM. I do not believe they could suspend them——

The CHAIRMAN. Have they taken any action to suspend them?

Dr. GRAMM. No. I think I will probably have to get back to you. It is my understanding that they could not suspend them, but they have asked the firms to keep some of the traders from trading for customer accounts, and that is how you have the difference of some of them not trading.

The CHAIRMAN. Is that all they can do, just say "you are under indictment, please do not trade?" I am not trying to be sarcastic——

Dr. GRAMM. It is my——

The CHAIRMAN. Let me please finish. I just want to make sure I fully understand this. All they, the exchanges, can do is say to the trader that while you are under indictment—realizing that cases go on for years and years and years with appeals—you, trader, are in the middle of trials or whatever, so please do not trade?

Dr. GRAMM. As I recall—and again, I will have to check on that, because these conversations were held several months ago——

The CHAIRMAN. I know, but the rules——

Dr. GRAMM. As I recall, they felt they did not have that, at least one exchange did not.

The CHAIRMAN. Well, Dr. Gramm, I am sorry I cut in here, but you are, after all, the Chair of the CFTC. Would you do me a favor and check and find out whether either you or the exchanges have the authority to stop these people from trading? It is a matter of more than the passing moment in this whole area.

Dr. GRAMM. I do know about the CFTC, and that is, with the CFTC, there is some question about our authority, that if we were to start a process, when we research it, we start a process, there would be some fair risk of losing that case.

The CHAIRMAN. I will tell you this. If there is some question on it, it has now become more than abstract and academic. Why do you not see if you can resolve the question and let us know because, if there really is a question, maybe we can resolve it in legis-

lation. This is critical to the way you could run the CFTC. It might be a good time to find out what the exchanges are able to do.

We have Senators Daschle, Cochran, and McConnell.

Senator Daschle.

Senator DASCHLE. Chairman Gramm, I would be interested if you could just tell us what your position would be, since you have considered it a good deal, and obviously the CFTC has come to the conclusion that, because of the legality matter here, that you may or may not have the authority, would you support legislation to clarify your authority to do this in the reauthorization bill?

Dr. GRAMM. Personally?

Senator DASCHLE. Yes.

Dr. GRAMM. I would support that.

Senator DASCHLE. You would support that?

Dr. GRAMM. Yes.

Senator DASCHLE. In response to so many of your questions today, you have indicated justifiable interest, in my view, in the need to be sensitive to international competition, but I think at the same time you have not shown the kind of sensitivity to consumer confidence. I think we have to be sensitive to both, and I am sure you would agree with that.

I think of all the things that the bill introduced by Senators Leahy and Lugar does, that would allow us to be sure that consumer confidence is attained in the future, is the one which enhances your enforcement powers, boosting your funding authority by 50 percent and expanding your powers to charge service fees to allow the adequate resources to ensure that you have the capability in the future. Do you support that?

Dr. GRAMM. I do support that. I would also say that we at the Commission are very cognizant of our role as primarily a role of customer protection and market integrity. That is the main mission of this Commission and we do carry that out vigorously. We do support the increase in resources, as well as the use of fees.

Now, whether or not the fees that are talked about here would support the whole increase or not—we indicated that the fees that are talked about here would support about a \$4.9 million increase in the fees that we do receive. But we do support the increase in the Commission's size, as well.

Senator DASCHLE. What would you do immediately upon receiving the additional authority to increase resources? Where would you put those resources?

Dr. GRAMM. Well, we already have a plan. I would like to increase our floor surveillance by 30. I also have in place a plan to increase the size, by small amounts, but for a small agency it is a significant increase, in our proceedings, which includes the reparations program and the information resources management area, because of the computerization that is occurring and the extra technical expertise that we need.

Across the board, we feel like we need resources for economic analysis, market surveillance, and enforcement. We have been increasing our Division of Enforcement. It is our largest division now, but we need more resources there. Also the Division of Trading and Markets, which has been the real workhorse over the past few years, is in sore need of more resources.

Senator DASCHLE. I do not know that you can compare the SEC and the CFTC in this regard, but I think it is appropriate to mention that, when it comes to resources, the SEC has four times the resources you do and had five times the enforcement actions you did last year. You had only one-fifth the enforcement actions the SEC did. Would you attribute that largely to your lack of resources?

Dr. GRAMM. I would not say it is entirely due to lack of resources. We have a smaller number of people that we regulate and there are a large number of other factors that account for that. We also have a very large reparations program and I think our arbitration program, that the exchanges and the NFA have, is effective in providing some recourse for customers.

Senator DASCHLE. I would ask if I could clarify something with regard to the oral statement you made, and you made it also in reference to one of the earlier questions. I do not recall now who it was, but you indicated that you have some concern about mandating technology in advance of evidence that the mechanisms are technologically feasible, practical or free of troublesome attitudes.

Referring, of course, to electronic trading, COMEX in the last couple of weeks announced that they will institute an electronic trading program. Other financial institutions in other parts of the world have already indicated that they find it to be a satisfactory means of trading. Are you referring here to electronic trading and, if so, in light of COMEX's decision, how do you find that there would be some difficulty in mandating technology that is already being used by one of the exchanges here in this country?

Dr. GRAMM. With respect to the COMEX decision, the hand-held technology, as well as to the GLOBEX technology, all of that technology, I would say that we at the Commission are very eager to monitor that very carefully. We have spent a lot of time and resources in the approval process in GLOBEX to ensure that those systems have integrity and are secure. But these systems are not in place yet, they are still at very early stages. At COMEX, for example, the hand-held system has not been tested yet, and GLOBEX is now being tested.

Given concerns over computer security and other issues, we want to be able to monitor very carefully those systems as they are tested. They are not in place yet and there could be some unforeseen problems. They might not work as well, they might have other problems, we do not know. So, that is just a concern, but that does not—

Senator DASCHLE. Let me just tell you, I really do not think, with all due respect, Dr. Gramm, that you have anywhere near the appreciation of the difficulty in perception that exists today with regard to the CFTC and consumer confidence. It seems to me every time anyone has brought up a problem today, you cited reasons why that particular action may be unwarranted, each one of them undermining dramatically the consumer confidence that people have in your regulatory ability.

Sooner or later, you are either going to enhance it or you are going to lose it, it is not going to stay the same. My hunch is that if the Commission continues to conduct itself in the way that it has

with this benign examination of what is happening in front of them, you are going to lose it, and this is just another example.

I think this bill and other opportunities like it, per se or not, is irrelevant, but we need to use this vehicle to give you the kind of ability necessary to send a message to the whole country that consumer confidence is of paramount importance and you are going to do all you can to ensure that it happens, and I frankly do not see that in the response to the questions that you have been asked this morning, nor in response to the kinds of opportunities the industry itself is taking to see that it happens.

So, I would hope that you would reconsider some of these things and, as you consider each and every one of your options, remember the importance of consumer confidence even more than the importance of international competition, because if we cannot keep our customers here at home, it does not matter whether we lose business abroad. We have to keep our customers here first.

Dr. GRAMM. Senator, I agree with you and I would say that questions have not been asked about the issues that we agree with and that we vigorously support in this bill, that this is—

Senator DASCHLE. Well, I do not see much vigor this morning.

Dr. GRAMM [continuing]. This is a bill that we think is very strong and has a lot of good elements to it. In fact the Commission has undertaken a lot of reforms and rules and we are in the process of proposing and implementing them right now, in response to the need for customer confidence. I would agree and the people in the industry have heard me talk about customer confidence and the need for reform. I put a speech into the record that I just gave at a recent industry conference on just that particular issue.³

Senator DASCHLE. Thank you.

The CHAIRMAN. Thank you.

We will go in just a moment to Senator Cochran and Senator McConnell and then Senator Gorton. Just so everybody will know the schedule, we will stay on this hearing until 12:30. I am going to be leaving momentarily to take over as the manager of an item on the floor and will come back. I will be in and out. We will go until 12:30, and then recess for the Republican and Democratic caucuses at that time. We will come back at 2:30.

Senator Cochran.

Senator COCHRAN. Thank you very much, Mr. Chairman.

Dr. Gramm, welcome to the committee hearing. Let me say that I know that the Commission has been at work reviewing the suggested changes in authority that are prescribed in this bill before us today and other changes that are designed to improve the confidence of those who use the exchanges and who trade, who are interested in the integrity of the system. It is my hope that this hearing will really enable us to understand what authorities the Commission needs that would equip it to do its job better, to reach the goals that we all have.

In that connection, in your review of the Leahy-Lugar bill that is pending now before the committee, what, if anything, would you ask the committee to include as new authority for the Commission

³ See pp. 69-75 for the remarks of Wendy L. Gramm, Twelfth Annual Commodities Law Institute, IIT/Chicago-Kent College of Law, October 12, 1989.

to enable it to do a better job or to meet some of the challenges that we face in this modern era?

Dr. GRAMM. I would say that there is one proposal, that was a recent proposal of the Commission, that the committee did not have or that Senators Leahy and Lugar did not have a chance to put in this bill that we would like to have, and that is a section that would give us the authority to get information from the unregulated affiliates of Futures Commissions Merchants. It is really one of the recommendations that came to us after the market events of October 1987. We have not necessarily had the need to use it this time in response to last week's volatility. However, it is an authority we believe is very useful. It would give us the ability to get information about potential financial risk of an affiliate of a firm that we would regulate. We would like that authority and I would be happy to have that included as well.

Senator COCHRAN. I hope that, as we proceed to a markup session, which I understand is scheduled for the near future, that you will provide some suggested language for us to include as an amendment in that way. I will be happy to offer that at the markup session.

Dr. GRAMM. Thank you. We have included that with our longer package for part of the record of this hearing.

Senator COCHRAN. I also have heard from some who are concerned about the authority that is given to the CFTC in this new legislation to impose service fees and in some way this could lead to a grasp for greater power or an impetus for the Commission to becoming a giant regulatory body as large as it wanted to become by just adding user fees or service fees to those exchanges who are regulated by the Commission, and we could end up with a hydra-headed monster that nobody could control, not even the Congress or the executive branch. What is your reaction to that? Do you see this service fee authority as a temptation by the Commission to really assume a lot more power than anybody right here may predict that they would like?

Dr. GRAMM. I think not. First of all, I think you should know that we would not have an incentive to ask for fees just to make ourselves bigger, because all the fees go directly to the Treasury. They do not come to the CFTC and we cannot, therefore, use them directly for our own staffing. They go to the Treasury, and that I think splits away the incentive for a bureaucracy just to tax in order to make ourselves bigger.

Also, any fees would have to be established by rulemaking. I also understand, I cannot remember the name of the act, but there is a law that says that we may not ask for fees that go above the cost of the service being provided, so that indeed could be limiting.

Senator COCHRAN. Do you see the requirements in the act for the electronic trading or the modern technologies to be included and put into operation within, I think it says 3 years here in the bill, that being so onerous a financial burden, that a lot of the smaller exchanges might actually be put out of business if that is carried forward and enacted into law?

Dr. GRAMM. I think it could possibly. I guess the question is that we do not know what the technology or what other kinds of technology are out there that might be developed that might indeed be

cheap enough for some of the smaller exchanges, and at this time it is hard to predict that.

Senator COCHRAN. Would we be better off with some sort of testing or study period, rather than just a flat edict that, no matter whether you came up with something that worked or not, you had to implement it just because it was new?

Dr. GRAMM. Actually, I think that a very small change in the language could do what I think what the Senate would like to do, and that is to push toward more precise audit trails, but give some flexibility. That is to put in the word "practicable" instead of "feasible". That is, these technologies would be implemented if practicable, because there might be something that is technologically feasible, but at great expense and, again, with other problems. Perhaps there is other language that could deal with the concern that there might be other problems that we have not seen yet that could make these systems troublesome.

Senator COCHRAN. Thank you very much, Dr. Gramm. I think your testimony this morning has been very helpful to the committee and I congratulate you for it.

Dr. GRAMM. Thank you.

Senator COCHRAN. Thank you, Mr. Chairman.

Senator McCONNELL. I think I am next, Mr. Chairman.

Senator HARKIN [presiding]. Senator McConnell.

Senator McCONNELL. Just a couple of questions, Dr. Gramm.

Would it be practical to place added restrictions on the opening and closing 15 minutes of trading, since those are higher volume times?

Dr. GRAMM. Yes, we have some rulemakings with respect to both the open and the close. There are some restrictions that are already being put in place. Let me turn to Alan Seifert, who can give you some details. But we have made some proposals as well as some exchanges have made some proposals. We think that the open and the close are areas where there have been some problems of violations and, therefore, are seeking to improve our monitoring of that area.

Senator McCONNELL. And what are you suggesting?

Mr. SEIFERT. There is a rule proposal out now that includes one provision that would require an audit trail designation for those trades that take place during the opening and closing trading period, that is those periods upon which the opening and closing ranges are based.

In addition, we are undertaking a rulemaking to require exchanges to have some provision for customer orders to be executed perhaps by some average price or some other mechanism that would provide customers with some heightened degree of assurance as to the quality of the executions that they receive during those periods of time.

Senator McCONNELL. In addition to looking at restrictions on the open and close, have you also looked at maybe restricting to certain pits? Have you looked at that way of getting at it?

Dr. GRAMM. I think you missed my opening statement, but I have in my opening statement, that we are concluding a study testing some hypotheses concerning the benefits of dual trading. Based on that and the problems associated with dual trading, we will be

working on a rulemaking to restrict dual trading. The details are not yet—

Senator McCONNELL. When do you expect that to be completed?

Dr. GRAMM. Well, what I would like to do is, in the next week or two, to release publicly the economic analysis that we have done on dual trading with a rulemaking proposal to follow hopefully by Thanksgiving. But the rulemaking, as we see it now, would be consistent with the provisions of the bill, the Senate bill now as it stands.

Senator McCONNELL. Dr. Gramm, one final question. I understand that a couple of years ago the CFTC created an Agricultural Advisory Committee.

Dr. GRAMM. Yes.

Senator McCONNELL. And I am wondering how extensive a use you make of this committee.

Dr. GRAMM. The Agricultural Advisory Committee is chaired by Commissioner Kalo Hineman, who is a long-time, 40-year producer—farmer and rancher. It is very valuable to the Commission as a way of getting input from the agricultural community and to give them information about what the Commission is doing. We found them very valuable, for example, in the latest soybean episode, getting their comments and views, as well as telling them what the Commission does and did during the particular events arising with respect to the May and July soybeans.

Senator McCONNELL. So, you call on them frequently, do you?

Dr. GRAMM. Typically, the meetings are every 6 months or so, but we can call them and did call an extra meeting this past summer and, indeed, Commissioner Hineman keeps in constant contact with all of its various members.

Senator McCONNELL. Thank you, Mr. Chairman.

Senator HARKIN. Thank you.

Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

Dr. Gramm, I guess I have a more fundamental question or a more fundamental position. I tend to agree with some of the frustration that was expressed earlier here by Senator Daschle. I am sorry, I spent the earlier part of this morning in a fascinating hearing on what went on in Panama last week and missed Senator Eagleton's statement, but as I read through Senator Eagleton's statement, I find a great deal with which I agree. He makes a conditional suggestion which I would make much less conditional, and I ask you to do the best job you possibly can to get out from under the hat you particularly wear and tell me why in the world there is any justification for the existence of the Commodity Futures Trading Commission.

I do not believe, to be perfectly frank with you, that any bill we can write—and I think this is a good bill—is ever going to cure the problem of a group of exchanges which are engaged in activities very closely paralleled to those which are governed by the Securities and Exchange Commission, governed by a completely separate Commission, with different people, operating under a different law and under an obviously different philosophy.

We lucked out on Friday and over the weekend when we had the tremendous disparity between futures trading and actual stock

prices in New York and we worried all weekend as to whether or not we were going to see a repeat of 2 years ago. It did not happen, but in my view, to a large extent, that simply was blind luck. Why in the world should not these exchanges be governed by the SEC?

Dr. GRAMM. Let me first of all make a couple of comments. First of all, as you know, futures products are different than stocks; futures are used for hedging and price discovery. In regulating futures the underlying cash market product is extremely important. In the case of soybeans, for example, we have to understand the soybean market to be able to understand soybean futures markets and to monitor those markets effectively. The same is true with the stock futures. Stock-index futures and the underlying cash markets that the SEC regulates are very closely linked.

With respect to what happened over the weekend, though, because I think you missed some of my earlier statements in which I indicated that over the last 2 years an awful lot has been done in response to the market events of 1987, not the least of which are coordinated circuit-breakers, increased communication among regulators, but also clearing and settlement changes. The events of the past week demonstrated that there was an awful lot of cooperation and coordination. We did have a test of the circuit-breakers and, while there obviously will be more studies, all of the circuit-breakers and the plans worked as planned, as programmed. Also, with respect to clearing and settlement, there were large amounts of intraday margins collected, and there were no financial problems at all on the futures side of any firm. The markets are calm today.

I do not think it was blind luck. I think that our activity with the working group and the reforms that were put in place got a test run this past weekend, and I think that everybody is generally pleased with how communication was coordinated. I think that such communication is appropriate, not only among the SEC and the CFTC, but also with the other regulators. The Fed and the SEC both came to our Sunday market surveillance meeting. We also communicated with the Department of the Treasury and the Council of Economic Advisers.

Senator GORTON. Coordination and cooperation are words we hear in all kinds of contexts, and there is no question but that some of the concepts and the commodities, the titles of what we do are different, but the money is the same. The money moves from Chicago to New York with great ease, as a matter of fact moves because of differences, in spite of all of these things that you have stated.

I have listened carefully, but I have not heard a justification yet for why we have two separate regulatory agencies governing the same kind of money, the same kind of temperament, the same kind of attitudes, the same kinds of either investment or speculation.

Dr. GRAMM. Again, I do think they are different markets. In earlier days people said there was somewhat of a conflict in having the CFTC as part of the Department of Agriculture. Our job is to ensure that these markets are basically price-neutral. We monitor the hedging function of these contracts, and the contracts are used for very different purposes, as opposed to what goes on elsewhere, what is regulated by the SEC.

Senator GORTON. Well, let me ask a question about elsewhere, and this is a pure question of fact. Is there any other country in the world with free markets which has two separate regulatory agencies for these two separate functions?

Dr. GRAMM. In England and in Japan you have separate regulators.

Senator GORTON. Obviously, I would appreciate an answer to that question, if you have a chance to look into it.

Dr. GRAMM. Yes.

Senator GORTON. Thank you, Mr. Chairman.

Senator HARKIN. Thank you, Senator Gorton.

Senator BOSCHWITZ.

Senator BOSCHWITZ. Thank you, Mr. Chairman.

I was not here for most of the testimony, having come in from Minnesota this morning, but I would like to ask you, Madam Chairman, several questions about the competition at our markets, the Board of Trade and, indeed, the Minneapolis Grain Exchange and others will probably be confronted with in years to come.

I wonder if you would give me—and I will ask the witnesses that are on the panel this afternoon as well—an overview of what kind of markets are developing around the world and under what kind of guidance and what kind of supervision and what kind of a threat that poses to continuation of the American dominance of futures markets. It is important, in my judgment, that we not so regulate these markets as to regulate them out of existence by allowing competition to arise. Is that a legitimate fear?

Dr. GRAMM. I think you raise some very good questions. As you know, we've had a preeminence in this country. Our markets are the oldest markets in the world. There is competition. There are markets from Japan to London and France, Switzerland, Singapore, Australia, Canada. I'd say that, in the financial futures area in particular, there is increasing internationalization; every country wants to be an international marketplace for financial futures. At the Commission, I have participated in international regulators meetings ever since I have been at the Commission. We have had an international regulators meeting that has met for 10 years in Switzerland. Then we host one, so that international regulators meet at least every 6 months if not more often. We're now as associate member of another international regulatory association.

I think that the questions you raise are probably questions that would take me a lot longer to answer as well. But, again, I would point out that the Commission has a great interest in the international competitiveness area. I would also point out, just for your information, that on the House side, the House reauthorization bill asks us to do a competitiveness study, much like a lot of the questions that you ask.

Senator BOSCHWITZ. I understand that there are some provisions to measure the competitive aspects of the industry that perhaps should be satisfied prior to this legislation and the impact of this legislation. There is a good deal of talk, both in London and in Tokyo, that efforts are now being made—I'm sure about Tokyo and I believe London as well—to gain a larger foothold, to gain a larger share of the markets, particularly the markets in international financial instruments.

I wonder if you would direct your attention specifically at the Japanese efforts. What are they doing and how are they regulated by comparison?

Dr. GRAMM. The Japanese markets are very interesting. They have many regulators, as a matter of fact. They have some markets that are open outcry markets much like ours. The futures markets for agricultural products are regulated by the Ministry of Agriculture, while the Ministry of Finance regulates other kinds of futures products. More recently, the Japanese have introduced financial futures. Stock-index futures on the Topix and the Nikkei have been introduced since last year and frankly have generated a lot of interest around the world.

Senator BOSCHWITZ. Is the degree of regulation—after the passage of this bill, and I presume it will be passed either in its present form or in a somewhat amended form, in your judgment will our exchanges be disadvantaged, or will they still be able to compete actively with the exchanges abroad? You said earlier in answering the question that it would take a little longer, and I don't want to pursue something that takes too much of the time of this committee. But I have a great interest in that, and I want to be sure that we remain competitive. I would rather have the wheat, soybeans, and monetary instruments traded here than traded elsewhere, where I have less of a sense of security with respect to how the regulation goes. Even if I were not to have a strong sense of feeling as I see that my former colleague, Senator Eagleton apparently doesn't, I think that that situation might not be improved if we regulate ourselves too assiduously.

Dr. GRAMM. I think on balance that this bill, with a few changes, is a strong and good bill that, indeed, would enhance, and wouldn't hurt, the international competitive position of the exchanges. But there are some areas, as we pointed out in our long testimony, where we think some improvements could be made. But on balance, we feel that this is a strong bill.

Senator BOSCHWITZ. I see my time is about to expire. I want to ask about the open outcry. I want to pursue the questions that my colleague from Mississippi did about the smaller exchanges and the necessity of imposing technology on them, the costs of that technology, and what the fees are to the industry. It's my understanding this bill will increase the budget of the CFTC in the 4 years from \$40 million to \$66 million, if I recall the figures correctly.

Dr. GRAMM. That's right.

Senator BOSCHWITZ. What percentage of those fees will be obtained from the industry?

Dr. GRAMM. In discussion at the staff level—

Senator BOSCHWITZ. Just the addition?

Dr. GRAMM. The addition. We had estimated about \$4.9 million would be collected in service fees as a result of this bill. That's a rough estimate.

Senator BOSCHWITZ. Annually?

Dr. GRAMM. Annually. In addition to the other fees already collected.

Senator BOSCHWITZ. I see that my time is expired. I will come back to those questions, both with you, Madam Chairman, and also with the witnesses on the panels this afternoon.

I thank you, Mr. Chairman.

Senator HARKIN. Thank you, Senator. I want to thank all the panel members for being here. You're excused now while we—

Senator BOSCHWITZ. I thought we were going to enter into another round of questioning. In that case, I'd like to pursue my questions.

Senator HARKIN. I'm sorry. I thought you were finished.

Senator BOSCHWITZ. No. I thought that Senator Conrad might want to go.

Senator HARKIN. I just arrived here a little bit before you did. I thought Senator Conrad had already questioned. I apologize, Senator Conrad.

Senator CONRAD. It was my understanding that we were just going to have the one round, given the number of witnesses here. I have lots of questions in addition, but I would be willing to hold on those. We have gotten through two witnesses, and I think we have two pages here.

Senator HARKIN. I'm at your disposal here. We're going to break by previous agreement from 12:30 to 2:30. So we have about another 25 minutes here. If it's the Senators' desire to continue questioning this panel, I certainly would not interfere with that. If you want to, go ahead.

Dr. GRAMM. Can we answer some questions for the record, Senator? Would you like to submit them to us and we can respond to them?

Senator CONRAD. I would be glad to do that. I tell you, I have loads of questions. I could take all day with this panel. I don't know if that's in the interest of the committee to do that.

Senator BOSCHWITZ. In that case, I will continue, if I may.

Senator HARKIN. Senator Boschwitz.

Senator BOSCHWITZ. Do other exchanges in other countries impose fees on their members for the purpose of the members paying for the regulation for their own oversight?

Dr. GRAMM. I will have to get that information for you. I do know that, for example, in the U.K. some of their self-regulatory oversight bodies are funded through fees.

Senator BOSCHWITZ. Again, please? Some of the oversight bodies?

Dr. GRAMM. The oversight self-regulatory bodies—namely, the SIB, Securities Investment Board—is funded with fees collected. But I will get more information.

Senator BOSCHWITZ. Perhaps one of your colleagues there is familiar with that, but I would like to ask the CFTC or its staff to prepare for me very quickly—because this bill is moving right along—what it believes the competitive nature of our exchanges will be within the imposition of these fees. I am not particularly opposed—and I don't mean to suggest that—to these fees, but I would be most chagrined if we legislate some of this business offshore, having a sense of the amount of activity that's created in the Middle West because of these exchanges. I believe that the two Senators from the State of Illinois were here and probably testified to that.

One of the things that apparently is quite a matter of dispute is the open outcry system. Senator Eagleton in his testimony says, "It serves absolutely no purpose in the age of GLOBEX, * * *. How

can electronic trading be an historic breakthrough in Singapore or Hong Kong, but a dreaded evil in Chicago and New York?"

I have been at these exchanges a number of times, quite a number of times, and when you see the open outcry, there is such a tumult going on you wonder how anybody keeps track of what's going on. But yet as discussed here, there are billions of dollars, Senator Eagleton pointed out, "billions and billions of dollars and in millions and millions of transactions." It's hard to believe there are millions and millions of transactions, but perhaps there are. Most of those are conducted honestly, I suppose; 99.9 percent are conducted well and honestly.

But what do you think of the necessity of the open outcry and whether or not there is a different necessity of the smaller exchange than a larger exchange, whether or not there might be a different necessity in an exchange that trades very large contracts—perhaps oil? And is the open outcry something that is a thing of the past, or is it still a necessary element in trading these contracts?

Dr. GRAMM. Senator, I've assiduously tried to keep from making predictions about market events that are current. One of the things that we have done at the Commission is to make sure that these markets are competitive, open, free of fraud, and they have the kind of customer protection and integrity that the Commodity Exchange Act calls for.

We have at the Commission in just the last year-and-a-half looked at new technologies, including the GLOBEX screen trading system that is in its very early stages. What we've looked at so far satisfies the open and competitive aspect of the Commodity Exchange Act. But whenever I've been asked about whether or not I think open outcry is a thing of the past and that GLOBEX is a thing of the future, I've always said that you often see technologies exist side by side, and that the market determines that; that we have seen screen trading systems that have been approved in the past, but they don't have large volumes at this point. And there are a number of screen trading systems that have not succeeded.

Open outcry has existed over a long period of time and obviously must be providing some benefits. On the other hand, there are certainly a lot of new technologies and innovations that are occurring. I guess the only question that this bill raises in my view, is whether it would allow some flexibility for adopting systems or not adopting systems that may turn out to have greater problems or may not be practicable. They may be feasible but may have other more serious problems or may, indeed, not be practical.

Senator BOSCHWITZ. Tell me about the smaller exchanges. My colleague from Mississippi, Senator Cochran, began to explore that with you in his questions. There is talk about automation, and as I go and see my exchange in Minneapolis, where I've been many times, the pit looks a good deal different than it does in Chicago. I have not been to Kansas City and some of the others. I have seen the statistics, so I have a sense of where the exchange in my town, how it relates to the others, at least in volume. Should there be different rules? And can a small exchange be reasonably expected to adopt these kind of automation techniques?

Dr. GRAMM. I think that even the small exchanges do have a fair amount of automation, but there are certain kinds of techniques that may be, indeed, very costly for them. I think that the Commission has always viewed vigorous competition among the exchanges as something very positive and has been very careful over the years in our rulemaking to establish standards that allow the exchanges to implement these standards in ways that are appropriate to the special conditions in their markets. That kind of flexibility could not only give you the end result that you want—that is, fair and clean markets—but also allow for small exchanges with differing kinds of problems and issues to not only exist but also to be able to compete.

The Commission has been sensitive to that and, in that regard, has always tried to establish performance type standards and allow some diversity in how those standards would be actually implemented among the different exchanges.

Senator BOSCHWITZ. I'm told that in order to raise \$5 million in fees on an annual basis, that that amounts to about a fee of 2 cents per transaction. That means that there must be 250 million transactions. That means 1 million transactions every working day.

Dr. GRAMM. Let me turn to my staff. Would that be about right? [Pause.]

Dr. GRAMM. Yes.

Senator BOSCHWITZ. A million transactions on each working day. Is 2 cents very much? I will ask that question of the panel this afternoon, too, what percentage of the gross profit is 2 cents and whether or not that's a fee that could create an uncompetitive situation.

I thank you, Mr. Chairman, for your patience. I think I have no other questions at this time though, again, I would like the Commission to prepare for me, so that I'd be very specific about what I request, whether or not we are going to make our own exchanges noncompetitive, number one; and, secondly, I would like to have a review of the regulations that are imposed upon the competition, the regulations that are imposed by the Japanese and in London. I don't think I need to know about every exchange, but the major exchanges that might be seen as competitors to our exchanges. In my business days, I used to have a little "war room," so to speak, where I kept very close track of what my competitors were doing. So I would like to know in this sense.

Dr. GRAMM. Yes. Senator Boschwitz, may I ask for a clarification on that? Is it true that you'd like this but a very, you might say, quick and dirty overview because you would like to have it quickly? Is that right?

Senator BOSCHWITZ. I want to have it quickly. I'm not sure that I—

Dr. GRAMM. I mean, because there is a long study and there's a short study.

Senator BOSCHWITZ. I presume that your staff has someone who can do that, quick but not too dirty.

Dr. GRAMM. Absolutely. We will do so. We will do it the best we can.

[The responses pertaining to the imposition of new technology contained in S. 1729 on the competitiveness of the U.S. exchanges

and regulations of futures transactions in various foreign jurisdictions was subsequently provided and follow:]

COMMODITY FUTURES TRADING COMMISSION,
WENDY L. GRAMM, CHAIRMAN,
Washington, DC, October 31, 1989.

The Honorable RUDY BOSCHWITZ,
Committee on Agriculture, Nutrition, and Forestry, United States Senate, SH-506
Hart Senate Office Building, Washington, DC.

DEAR SENATOR BOSCHWITZ: In the Senate Agriculture Committee hearing on October 17, 1989, you asked me to provide you with information regarding the imposition of new technology contained in S. 1729 on the competitiveness of the U.S. exchanges, particularly the smaller ones.

As you know, each exchange currently makes significant use of modern data processing equipment and systems in its clearing and recordkeeping. S. 1729 would mandate standards of technology that would lead to imposition of screen trading or other electronic systems on all U.S. markets whether or not these systems are practicable for specific exchanges and markets.

In response to your inquiry, the Commission has gathered preliminary estimates as to the costs of technologies which would be required by S. 1729 from the three exchanges which are currently developing hand-held trade recordation systems. The Chicago Board of Trade (CBT) projects that its overall cost for installing hand-held or screen trading systems would be at least \$114 million, while the Chicago Mercantile Exchange (CME) estimates that its cost could be \$76 million. Both these exchanges state that implementing the standards of S. 1729 could lead to major reconfiguration of their trading floors. The CME and CBT calculate that such changes could cost them an additional \$30 million and \$100 million, respectively. Also, the Commodity Exchange, Inc. (COMEX) has estimated that the development of hand-held computer terminals to be used by locals to replace trading cards could cost it and the other exchanges of the Commodity Exchange Center in New York City approximately \$6 to \$8 million. Such terminals would not satisfy all of the audit trail requirements of S. 1729. In general, such terminals only would address the standards related to the timing of trade executions.

The costs associated with the technology mandated in S. 1729 are the estimates provided to the Commission by the exchanges. The Commission has not validated the exchanges' methodologies in preparing these estimates nor verified the data upon which the exchanges have relied. Since the exchanges' estimates necessarily have been based on systems that are in their initial stages of development they may be subject to substantial change. For instance, CME currently states its estimated cost could move as much as 25-40 percent in either direction.

For the larger exchanges, the high estimated fixed costs of new technological systems can be spread among a greater number of exchange members. For smaller exchanges the high cost of these systems will have to be borne by a more limited number of exchange members.

In assessing the significance of these costs, the Commission believes that the practicability of the new technology being mandated in S. 1729 should be considered. Before that assessment can be made, the technology needs to be developed and tested. That process could indicate unforeseen problems with the systems' application to the futures markets.

I appreciate this opportunity to address preliminarily your concerns and would be pleased to discuss further any aspect of this matter with you at your convenience.

Very truly yours,

WENDY LEE GRAMM,
Chairman.

COMMODITY FUTURES TRADING COMMISSION,
WENDY L. GRAMM, CHAIRMAN,
Washington, DC, October 31, 1989.

The Honorable RUDY BOSCHWITZ,
Committee on Agriculture, Nutrition, and Forestry, United States Senate, SH-506
Hart Senate Office Building, Washington, DC.

DEAR SENATOR BOSCHWITZ: During my testimony on October 17, 1989 before the Committee on Agriculture, Nutrition, and Forestry, you inquired about the regulation of futures transactions in various foreign jurisdictions and how such regula-

tions compare with the regulatory system in effect under the Commodity Exchange Act ("Act") and regulations thereunder.

In responding to your inquiry, the Commodity Futures Trading Commission, as requested, is providing a short synopsis of the regulation of futures transactions and markets in three jurisdictions: (1) France, (2) Japan and (3) the United Kingdom. Futures trading on markets located in the United States and in these three jurisdictions accounts for nearly 90 percent of global trading volume. The information with respect to these three jurisdictions is set forth below as follows: (1) the structure of regulation in such jurisdictions, including whether the regulators in each such jurisdiction charge transaction fees as a source of revenue; (2) exchange related issues such as the existence of position limits, whether dual trading is permitted on the exchanges and whether requirements exist relating to audit trail; (3) competitive issues relevant to such foreign jurisdictions; and (4) how these jurisdictions address customer protection concerns. In addition, I also wish to take this opportunity to supplement my testimony on October 17 regarding transaction fees.

FRANCE

a. *Regulatory Structure.*—Although the French Ministry of Finance has oversight duties and the Banque de France also has jurisdiction over certain financial instruments, the primary responsibility for regulating the futures and option markets in France and for ensuring customer protection rests with the French Commission des Operations de Bourse ("COB"), an independent regulatory agency, and the Conseil du Marche a Terme ("CMT"), a self-regulatory body with the authority to regulate French futures markets and to control and sanction firms engaged in futures business. The basic laws governing futures markets and professionals are *Law dated March 28, 1885, as amended by Law No. 85-695 dated July 11, 1985, Law No. 87-1158 dated December 31, 1987, and Law No. 88-70 dated January 22, 1988.*

Prior to 1984, the COB's operations were financed by the French government. Since 1984, however, the COB has been funded by fees imposed on the issuance of equities and bonds and take-over bids (0.2 percent of the funds involved) and annual fees assessed on mutual funds (.02 percent of fund's net assets). For 1988, the COB collected US\$12,700,000 in fees. The COB imposes no fees on futures transactions. However, all exchanges collect a sales tax (18.6 percent of a firm's clearing fees) from their members which is paid to the French government. No tax is collected if neither the broker nor his client is resident in France or in a European Economic Community country.

b. *Exchange Issues.*—French Law No. 87-1158 merged the commodity futures and financial futures markets into one market, the MATIF, on which is traded the French Notional Bond (the French Government debt) contract, the 8th most actively traded contract in the world for 1988. A second financial futures exchange, Options Market France ("OMF"), was authorized by CMT in 1988. The OMF is currently trading, among other things, a stock-index futures contract, the OMF 50. No standards or criteria exist regarding the recognition of French futures markets and each application for recognition is examined on a case by case basis.

With respect to audit trail requirements, the Commission has been advised that time stamping is required with respect to orders when the order is received by the broker, when the order reaches the market and when the transaction is executed. Dual trading is permitted on French markets subject to the restriction that the firm subordinate its interests to those of the customer. On position limits, although no strict position limits are imposed, MATIF has promulgated certain "prudential" rules which act to limit the number of positions firms and customers may control. Most significant of these is the restriction that the aggregate of all open positions for any particular contract of any customer or firm may not exceed at any time 20 percent of the market open interest in that contract. The other restrictions are a function of the firm's or customer's net worth.

c. *Competitive Concerns.*—In France, no restrictions exist on the ability of French customers to trade in foreign futures markets or on the ability of persons in jurisdictions outside France to use French markets. However, until the adoption of Law No. 87-1158, firms were not permitted to, among other things, *solicit* French customers for transactions on markets located outside France. This law now permits public solicitations for futures and securities products sold in markets outside France if the foreign jurisdiction in which the market is located permits public solicitations for French products.

Law No. 89-531 dated August 2, 1989, permits the COB to recognize a foreign market provided that the jurisdiction in which the market is located recognizes

French markets. The ordinance which would implement this provision of Law No. 89-531 has yet to be adopted.

Thus, French treatment of foreign markets and brokers appears to be based on the principle of reciprocity. Another example of the application of this principle is that the COB has been granted an exemption from the operation of the French blocking statute so that it may provide information to foreign regulators provided such regulators, among other things, have the authority to provide and agree to provide similar information to French regulators.

d. *Customer Protection*.—The French regulatory system for ensuring customer protection includes registration requirements, minimum financial requirements, protection of customer funds, maintenance of books and records, sales practice standards and compliance procedures. To obtain registration, applicants must provide information evidencing their good standing, including the integrity and moral character of officers and directors, and meet strict capital requirements imposed by the CMT. Although customer funds are not required to be segregated as in the United States, the COB has advised the Commission that other measures exist to ensure the protection of customer funds. In addition, there are extensive record-keeping requirements designed to permit complete and accurate tracing of all transactions and customer funds. Disclosure obligations also are imposed on firms dealing for customers. Compliance with customer protection requirements is monitored and enforced by the COB and CMT.

JAPAN

a. *Regulatory Structure*.—In Japan, the regulation of futures trading as in the United States is a federal function. The primary function of the regulator is to oversee the self-regulatory activities of Japanese exchanges. Unlike the United States, however, there is no single law or regulatory body to regulate futures trading and depending on the particular futures contract, one of three Japanese Ministries may have jurisdiction over the contract and the exchange on which that contract is traded. The Japanese Ministry of Finance ("MOF") regulates financial futures instruments, such as futures contracts on stock indices and on currency instruments. The Ministry of Agriculture, Forestry, and Fisheries ("MAFF") regulates agricultural commodities such as grain and sugar. The Ministry of International Trade and Industry ("MITI") regulates industrial commodities, including metals such as gold, silver and platinum.

More specifically, the MOF regulates the new Tokyo International Financial Futures Exchange ("TIFFE") which opened in June 1989 and which trades three financial futures instruments, the futures on the three-month Euroyen, three-month Eurodollar and Japanese Yen-United States dollar currency. The MOF also regulates the Tokyo Stock Exchange ("TSE") and the Osaka Stock Exchange on which the Yen Bond and certain stock-index futures contracts are traded. Depending on whether a particular firm engaging in these transactions is a securities firm or a banking firm, either the Securities or Banking Bureaus of MOF will have jurisdiction with respect to that firm. The basic statutes which govern financial futures transactions are the *Securities and Exchange Law, Law No. 25 of April 13, 1948*, and the *Financial Futures Transactions Law, Law No. 77 of 1988 ("FFTL")*. The latter law authorized the establishment, and governs the operations, of TIFFE.

Transactions in agricultural and industrial commodities are governed by the *Commodity Exchange Law, Law No. 239 of August 5, 1950 ("CEL")* and two regulatory authorities administer that statute, the MAFF and the MITI. Twelve exchanges, of which the Tokyo Grain Exchange is the largest, trade agricultural commodities under the supervision of the MAFF and the remaining four exchanges, of which the Tokyo Commodity Exchange for Industry is the largest, trade industrial commodities under the supervision of MITI. MAFF and MITI issue joint "Ordinances" to fully implement the CEL.

At the present time in Japan, a transaction tax is imposed on transactions on Japanese securities markets. This transaction tax also is applicable to certain financial futures transactions on those markets. The tax rate imposed on financial futures transactions, however, is lower than the rate for securities transactions. For example, on the TSE, the tax rate for the Japanese Yen Bond is .01 percent of the value of the transaction while the rate for the futures contract on the Yen Bond is .001 percent of the trading value. It is expected that in the spring of 1990, a transaction tax will be imposed with respect to transactions on TIFFE. The Commission also understands that a tax is imposed on transactions on the commodity exchanges regulated by MAFF and MITI. In addition, in the fall of 1988, the Japanese government imposed a controversial 3 percent sales tax which also applies to all brokerage

commissions. The revenue derived from the transaction tax and the sales tax are designated as general revenue for the government.

b. *Exchange Issues.*—Both the FFTL and the CEL require that in submitting an application for registration as an exchange, the exchange must provide information with respect to, among other things, qualification of members, auditing and disciplining of members and conduct of business. The statutes generally provide that the appropriate Minister may issue an order recognizing an exchange if he is satisfied that the rules of the exchange are in accordance with law, that they ensure fairness in transactions and protection of those who trade on the exchange and that sufficient prospect exists for volume of transactions necessary to trade contracts in a fair and orderly manner in light of the prevailing economic circumstances.

The Japanese markets do not operate under strict audit trail rules. Dual trading is permitted on Japanese markets subject to the requirement that firms subordinate their interests to those of their customers. In the financial futures area, position limits are applicable to customers and firms based on, in the case of a customer, the amount of funds held in custody for that customer at the firm, and with respect to the firm, the firm's net assets. Thus, with respect to financial futures, no direct limits are imposed on the specific number of contracts in any single commodity which may be held or controlled by any one person. The Commission understands, however, that TIFFE has reportable levels on the three contracts which it currently trades. The CEL contains reportable position limits with respect to, among other products, agricultural products, rubber, certain textiles and gold and the Commission understands that certain of the commodity exchanges, such as the Tokyo Grain Exchange, maintain specific position limits which may be exceeded by permission from the exchanges.

c. *Competitive Concerns.*—All persons domiciled in Japan may trade in the agricultural and industrial commodities which in Japan are subject to regulation under the CEL in markets located outside Japan. Prior to June 1989, only those Japanese entities which qualified as Designated Financial Institutions ("DFI") pursuant to guidelines issued by MOF could trade in foreign financial futures products. These restrictions have since been lifted and retail customers and non-DFI's may now trade these products. The Commission also has been advised that capital requirements on firms doing business in Japan are very high. For example, non-Japanese members of TIFFE are required to maintain capital of 5 billion yen (US\$35,395,000) and the figure for Japanese members is substantially higher. Notwithstanding the reduced capital required for non-Japanese firms, these requirements are significant.

d. *Customer Protection.*—Both the FFTL and the CEL contain provisions relating to customer protection such as licensing standards applicable to firms and their personnel, minimum financial requirements, protection of customer funds, maintenance of books and records, sales practice standards and compliance procedures. The manner in which the majority of these issues are addressed in the statutes is similar to the manner in which such issues are addressed in the Act and regulations thereunder. However, the statutes are implemented by the appropriate Japanese Ministry through the issuance of formal or informal rules, ordinances or guidelines. Accordingly, the Commission is unable to make any assessment regarding the degree of similarity of United States and Japanese approaches to ensuring customer protection. The Commission understands that the governmental regulators have the authority to take whatever action they deem necessary to protect customers and the integrity of markets which they regulate.

UNITED KINGDOM

a. *Regulatory Structure.*—Investment business in the United Kingdom, including futures and option transactions, is governed by the Financial Services Act 1986 ("FSA") which establishes the framework for the regulatory structure currently in effect in the United Kingdom. Under this structure, the Securities and Investments Board ("SIB"), pursuant to powers delegated by the United Kingdom Secretary of State for Trade and Industry, is responsible for monitoring and enforcing compliance with rules which it has promulgated, investigating complaints, and promoting and maintaining high standards of integrity in connection with investment business. The SIB, in turn, also recognizes exchanges, clearinghouses and "self-regulating organisations" ("SRO's"), like the United Kingdom Association of Futures Brokers and Dealers ("AFBD") and The Securities Association ("TSA"), which are membership organizations and which function in a manner similar to that of the National Futures Association and National Association of Securities Dealers, respectively. The SIB is funded by annual fees imposed on the organizations which it recognizes, e.g., SRO's, exchanges and clearinghouses. The exchanges and clearinghouses are

charged on a per trade basis (with specified caps) while the SRO's are charged on an actual time cost basis. For the 1988-1989 fiscal year, the SIB collected approximately US\$21,000,000 in fees from entities which it regulates. Six percent of that amount was collected from the AFBD and 21 percent was collected from TSA. The SIB does not regulate the manner in which the SRO's collect fees from their members.

b. *Exchange Issues.*—The FSA mandates that before SIB may recognize an exchange domiciled in the United Kingdom as a "Recognised Investment Exchange" ("RIE"), it must be satisfied that the exchange has rules and procedures which, among other things, promote the proper conduct of business, ensure orderly markets and adequate price transparency and facilitate an efficient audit trail. Thus, all of the RIE's have rules which address and provide for an efficient audit trail. Dual trading is permitted on RIE's subject to the condition that in executing trades for their own account, firms subordinate their interests to those of their customers. At the present time, no rules exist in the United Kingdom regarding position limits on contracts similar to those which exist in the United States, however, the primary United Kingdom clearinghouse, the International Commodities Clearinghouse, is considering imposing such limits.

To date, the SIB has recognized the following futures exchanges in London: London International Financial Futures Exchange, London Commodity Exchange, London Metal Exchange, Baltic Futures Exchange and the International Petroleum Exchange. In addition to the foregoing, before any person in the United Kingdom may engage in any transaction on any overseas investment exchange, such an exchange must be designated for that purpose by the SIB. The United States futures and securities exchanges which have submitted the appropriate documentation have obtained the necessary designation by the SIB so that persons resident in the United Kingdom may engage in futures and option and securities transactions on markets in the United States.

c. *Competitive Concerns.*—With respect to competitive concerns, Part IX of the FSA addresses reciprocal facilities for financial business. Specifically, that Part provides that if the Secretary of State for Trade and Industry determines that if any country outside the United Kingdom, either through its laws or any action by or the practices of the government, does not permit persons "connected" with the United Kingdom to carry on, among other things, investment or banking business in that country on terms as favorable as those on which persons connected with that country are able to carry on such business in the United Kingdom, he may affect the ability of persons "connected" with the foreign country to conduct investment business in the United Kingdom.

d. *Customer Protection.*—In the United Kingdom, customer protection is monitored in the first instance by function based SRO's, such as the AFBD which has primary responsibility for monitoring compliance with customer protection rules which relate to futures and option transactions. The rules in effect in the United Kingdom regarding qualification to do business, minimum financial requirements, protection of customer funds, book and recordkeeping requirements, sales practice standards and compliance procedures are similar to those in effect in the United States.

Specifically, in determining whether a person is "fit and proper" to do investment business, the SIB will take into consideration a person's honesty and integrity, level of experience, prior convictions, bankruptcies and any other factor which may be relevant to such person's ability to carry on investment business. In addition, firms are subject to minimum capital requirements, although unlike in the United States, letters of credit are viewed as good assets and may be used to satisfy a portion of such capital requirements.

In the area of protection of customer funds, although the rules in effect in the United Kingdom are very strict and require that the funds of the firm be segregated from the funds of the customer, the rules also permit certain commercial and sophisticated investors to opt out of segregation. No such option exists under United States law.

Finally, as in the United States, the United Kingdom regulatory system addresses sales practice standards, including required risk disclosures, compliance procedures and the maintenance of books and records.

Part 30 of the Commission's rules regulates the trading for or on behalf of customers resident in the United States on commodity markets located outside the United States. Those rules provide that the Commission may exempt firms located in foreign jurisdictions which impose a comparable regulatory system and which have entered into cooperative information sharing arrangements with the Commission from the application of such rules. The Commission granted comparability relief to firms located in the United Kingdom on May 15, 1989.

TRANSACTION FEES

With respect to your specific inquiry relating to transaction fees, as you can see, foreign governments impose substantial fees on the entities which they regulate or on the users of the markets. S. 1729 does not impose a transaction fee on the United States exchanges. Rather, it directs the Commission to establish fees for its services and activities and focuses on specific areas where the Commission should be recovering some of its costs of regulating these markets. As I indicated in my testimony before the Agriculture Committee on October 17, our preliminary estimates are that an additional \$4.9 million annually would be assessed under this authority.

The bill provides for a rulemaking before the imposition of such fees and in developing any new fees the Commission would consider both the level of costs to the Commission of performing its services as well as the burden of certain other costs being borne by regulated persons. This is similar to our developing and administering the existing fees. For instance, in FY 1989, the rule enforcement review fees for the Chicago Board of Trade and the Chicago Mercantile Exchange were \$164,000 and \$163,200, respectively, while the fees for the Kansas City Board of Trade and the Minneapolis Grain Exchange were \$41,700 and \$43,400, respectively. These numbers reflect the differences in the Commission's costs of conducting these reviews. The Commission's overall assessment is that with a few changes, S. 1729 would not be detrimental, and in fact, could enhance the international competitiveness of the United States exchanges.

I appreciate this opportunity to address your inquiry and to supplement the record and would be happy to discuss further any aspect of this matter at your convenience.

Very truly yours,

WENDY L. GRAMM,
Chairman.

Senator BOSCHWITZ. I thank you, Mr. Chairman.

Senator HARKIN. Thank you, Senator Boschwitz.

I thank the panel for being here. You're excused.

Dr. GRAMM. Thank you.

[The prepared statement and attachments of Dr. Gramm follow:]

Prepared Statement of
Dr. Wendy L. Gramm
Chairman
Commodity Futures Trading Commission
Before the
Senate Committee on Agriculture, Nutrition,
and Forestry
October 17, 1989

We at the Commission think that S. 1729, the "Futures Trading Practices Act of 1989," is a strong bill that in general adopts sound and focussed legislative approaches to address many of the difficult issues that have arisen in recent months. Like H.R. 2869, the Commission's reauthorization bill passed by the House, S. 1729 is designed to increase public confidence in the integrity of futures markets by diminishing the potential for trade practice abuse and strengthening the Commission's regulatory systems. Both bills seek to address many of the alleged trading abuses that have been set forth in the Chicago indictments and the Commission's associated enforcement actions.

There are some areas where both H.R. 2869 and S. 1729 agree on the need for particular statutory changes. As you will recall, on January 23 and July 17, 1989, we submitted for consideration by the Committee our recommendations for amendments to the Commodity Exchange Act. As explained in those submissions, these amendments would enhance the enforcement of the Act by providing for cooperation with foreign futures law enforcement authorities, nationwide service of process and venue in private rights of action, flexibility in imposing civil monetary penalties and registration of floor traders. We are pleased that all of these proposals have been incorporated in H.R. 2869 and S. 1729, although as I will discuss, an important part of one amendment has been omitted from the Senate bill. More recently, on October 4 and 6, 1989 we submitted for consideration by the Committee three other amendments to the Act. One would enable the Commission to adopt rules requiring certain firms to provide reports on their activities which have the potential to affect the financial condition of futures commission merchants with which they are affiliated. The second concerns telemarketing fraud, which I will discuss in more detail below. And, the third removes Commission personnel from the government-wide salary and

classification limitations. I would request that our letters and explanation of all of our proposed amendments be included in the record of this hearing.

There is a similar consensus in both bills over higher standards for registration and the need for ethics training for Commission registrants. The Commission believes it particularly important that registrants be educated in the purpose and function of futures and options markets and in the rules and regulations which they must observe to legally trade in these markets. It is essential that all industry participants understand the significant sanctions they face if they abuse the markets and violate the law.

I would now like to discuss some of the other aspects of S. 1729.

Floor Surveillance and Dual Trading

S. 1729 will require each contract market immediately to enhance its trade monitoring systems through physical surveillance, audit trail recordation, trade reviews, and increased resources. The audit trail system must accurately record the times of trades in increments of not less than one minute, as now required by Commission rule, and the sequence of trades for each broker and trader. Beginning in 3 years, the audit trail must record the time of execution and essential data for each trade accurately and promptly using a source independent of the trader. We understand a mechanism into which the trader enters the data such that the data may not thereafter be altered would satisfy this requirement. In addition, to the extent determined feasible by the Commission, the audit trail is to have independent source records that include the times and sequence in which orders are received on the floor, received by the floor broker for execution, and reported from the floor.

S. 1729 will also require that not later than one year after enactment and at least every 2 years thereafter, the Commission must assess the trade monitoring system of each contract market. If the Commission finds that a contract market has failed to show that its systems comply with the statutory standards, the Commission must issue an interim order specifying the deficiencies and the necessary corrective action.

Under the bill a Commission interim order is to become final in not less than twenty days, subject to affording the contract market the opportunity for a hearing to petition to rescind, delay or modify the order on various grounds, including that the deficiencies cited have been or are being corrected

or that the timetable to correct the deficiencies is arbitrary. To cure deficiencies the Commission can order the contract market to make regulatory changes, hire more staff, remove officers or employees or suspend dual trading.

As a separate requirement, S. 1729 provides that within one year the Commission must issue an interim order to suspend dual trading in a contract market unless that market can demonstrate (1) that its trade monitoring system fully satisfies the new accuracy standards such that the system is capable of and is being used to detect and bring disciplinary actions or (2) that a suspension of dual trading would harm the public interest in hedging and price basing and that other remedies are more appropriate. A suspension order may provide certain exceptions.

While an interim or final order is in effect, the Commission may refrain from designating new contracts for the exchange. A final Commission order would be reviewable in a court of appeals under the same terms and conditions set forth in section 8a(9) of the Act for review of Commission emergency orders. Failure to comply with a Commission order will constitute a violation of a Commission order for purposes of establishing liability and assessing penalties in administrative law enforcement actions.

The Commission will be required to report to Congress within 3 days of issuing an interim or final order, and annually on actions it takes under these provisions. The Commission must also report to Congress in 2 years on the progress each market has made in developing systems to independently and precisely record transactions and on its recommendations to extend the schedules or to modify the standards set forth in the bill.

On the whole we believe that these provisions of S. 1729 will buttress the Commission's existing oversight program. We have reservations, however, about the resource implications of the bill's requirement that we must complete the first review of all exchange systems within one year even though subsequent reviews are on a two-year cycle. We would prefer a two-year cycle from the outset. Our current practice is to complete rule enforcement reviews at each of the exchanges on a biennial schedule. This takes account of the number of exchanges and the intensity of review required to evaluate the efficiency of exchange compliance programs. We understand that the bill effectively codifies our existing practice and provides procedures for issuing a Commission deficiency order in the case of exchanges that have deficient programs. However, we

do not interpret the bill as eliminating our ability to proceed more informally and to encourage improvements between or at the conclusion of two-year cycles without issuing deficiency orders. Nor do we believe the bill requires the Commission to issue an interim order if we consider a contract market to be in substantial compliance with the stated standards even though there may be nonsystemic shortcomings in an exchange's trade monitoring system.

Generally the bill's approach regarding audit trail should facilitate an improved audit trail, which has been a long-held Commission goal. We have moved aggressively toward this goal since 1986. We are firmly committed to improving the audit trail in the ways that are most effective in detecting and deterring trade practice abuse and we have recently proposed and adopted rules aimed at achieving that result. We do have some concerns over mandating that technical mechanisms must be in place within three years to capture data for pit trading in advance of any proof that installation of these mechanisms are technologically feasible, practicable, or do not have other more serious problems. In this regard, we believe the bill should be modified to employ the term "practicable" rather than "feasible." In our view, this would assure that both the costs and the utility of the new systems be considered as the exchanges proceed and the Commission monitors developments.

The Commission is just completing its study of dual trading which was initiated earlier this year. In this study, we measured the extent of dual trading and did some statistical analyses of the possible benefits of dual trading. In summary, the vast majority of dual traders are highly specialized as either customer traders or personal traders. Further, tests of relative performance do not indicate that dual traders as a group are superior traders or brokers compared to nondual traders. The analyses also indicate that dual and nondual traders are similar in terms of the liquidity they provide to the market. Our results indicate that dual traders do not trade more intensively in either low volume markets or more distant trading months.

Based in part on these results and the problems associated with dual trading, the Commission is prepared to write rules to restrict dual trading subject to certain exceptions. These exceptions as well as details of implementation will be described in the proposed rules and published requesting public comment. We believe this regulatory initiative taken under our existing authority will adequately address

the concerns that motivated the proposed legislation to limit dual trading contained in both the Senate and House bills.

Under the bill's deficiency order procedures, the Commission will be able to move expeditiously to remedy deficiencies and will not be required to hold a trial-type hearing on the record before issuing orders, except when ordering removal of exchange officials. While we support this general approach, we believe individual misconduct on the part of exchange officials is better addressed through traditional enforcement cases, the existing exchange disciplinary system or exchange personnel procedures than within a framework designed to deal expeditiously with institutional deficiencies.

S. 1729 seems to recognize this distinction since removal is the only remedy that requires the Commission to provide a hearing on the record. That kind of a hearing also creates the prospect of a protracted process that could interfere with what is designed to be an expeditious method to cure systemic problems. We therefore recommend that this provision be deleted from the bill.

Broker Associations; Oral Orders

The bill provides that in 270 days after enactment a floor broker or trader who is a member of a broker association may not make a trade or execute a customer order if the broker or trader knows the opposite party to the transaction is a partner or other affiliate with the same association, except under Commission rules that we have certified to Congress which require procedures and standards designed to prevent violations of the Act attributable to this type of trading. Each contract market must provide for disclosure of broker association arrangements to the relevant exchange and to the Commission.

The bill also provides that in 270 days oral orders on the floor of a contract market for member-to-member trades will be banned unless they are made pursuant to Commission rules certified to Congress that are designed to ensure that such orders are not used to facilitate violations of the Act.

We believe the bill adopts a flexible approach. It is important for the Commission to define and identify broker associations for the purposes of surveillance and compliance programs. We have interviewed broker association participants and are completing a study on current exchange practices. Our study should be completed later this fall. It may be that trading among members of broker associations can be readily monitored to avoid market

abuses that may occur as a result of such trading. Effective monitoring of broker association activities also may well require trading restrictions that are tailored to particular markets. In this regard, we think that continued trading between members of broker associations could be based on rules which define broker associations and provide for monitoring of their trading and appropriate prosecution of any violations detected as a result of this process. We would prefer that the bill be revised to permit the Commission to transmit rules to Congress without certification.

Similarly, we are also in the process of assessing the impact of oral orders between exchange members to determine if special rules are needed to curb any trading abuses. In this regard, however, we would prefer that the bill be revised to permit the Commission to determine that its oral order rules are designed to prevent violations, as in the case of broker association rules, rather than designed to "ensure" such orders will not facilitate violations. No rule can ensure there will be no violations. However, it can be written in such a way to significantly prevent or deter violations.

Governing Structure

Under Title IV of S. 1729, the Commission must adopt rules in 270 days to implement several requirements affecting exchange governing boards and disciplinary committees. These include provisions to assure diversity of interests on the governing boards with at least 20 percent to be nonmembers of the exchange, diversity of representation on major disciplinary committees to prevent special treatment or preferences for any person in the conduct of disciplinary proceedings, and notice to the ultimate customer if a contract market disciplines a member regarding execution of the customer's order that caused the customer financial harm.

Futures associations would similarly be required to assure diversity of governing boards and disciplinary committees.

Contract markets must also provide that no member may serve on any oversight or disciplinary panel for a period set by the Commission if the member is found to have violated the Act or any other law reflecting on the member's fitness to serve in a fiduciary capacity.

Finally, each contract market must have rules to avoid conflicts of interest in board and committee deliberations and to require a board or committee member to abstain from voting and deliberating on an issue if the member is, or certain related persons

are, to the member's knowledge, specific and actual parties in interest. We understand that voting and deliberation may be permitted, however, on issues that may affect prices on actively traded contracts if the member makes required disclosure of the member's market positions and the positions of affiliates of which the member is aware.

The Commission supports and has already published rules barring individual members with significant disciplinary records from service on disciplinary or governing panels of exchanges for a fixed period of time. We believe that the bill's provisions for diversity of membership for disciplinary panels are sufficiently flexible to assure that the technical expertise of the group can be retained so as to render prompt, effective and appropriate decisions. However, we question the 20 percent "nonmember" requirement for governing boards. While we favor the concept of outside board members, we are concerned that a statutory quota system may not always achieve the desired results.

In addition, we believe that a statutory requirement regarding conflicts of interest for voting and deliberations of the governing board and major disciplinary committees should not change the legal standard for review of exchange decision making. We understand that all exchanges already have procedures and practices in place to assure that interested members are subject to appropriate screening and recusal requirements. Further, the Commission could specify more formal procedures under existing law if it believed these were necessary or appropriate. Nevertheless, we believe that S. 1729 takes the correct approach in focusing on "specific" and "actual" conflicts and by allowing "interested members" to participate in deliberations and voting if disclosure of interests is made. We also are pleased that the bill directs the Commission to provide guidance through rulemaking of appropriate disclosure procedures. This recognizes that Commission expertise is necessary to assure that the conflict of interest provision will not result in the unwarranted removal from the exchange decision-making process those members with vital expertise whose firms or affiliates have a position in the market.

Penalties

In addition to the Commission's proposal to streamline civil money penalty procedures, Title VI of S. 1729 provides for expanding the Act's principal anti-fraud provision; increased monetary penalties and fines in Commission enforcement and criminal cases; explicit recognition of the principal/agent

relationship between futures commission merchants and floor brokers in certain cases for purposes of establishing liability under the Act; exemplary or punitive damages for customers in reparations, court and arbitration cases for willful and intentional violations; the ability of the Commission to order customer restitution in administrative enforcement actions; class actions in reparations; and felony sanctions for giving false information to self-regulatory organizations as well as for willful violations of the Act or Commission regulations and for certain false statements.

Under the bill, the Commission is also to study penalties it and the exchanges impose and to report to Congress in 2 years on whether systematic differences exist. The report shall include proposals as determined appropriate and necessary for industry wide standards and guidelines to make penalty levels consistent, including minimums or ranges.

The Commission supports most of these amendments and believes they will significantly enhance the range of law enforcement and customer remedies already available under the Act.

A majority of the Commission, however, does not support empowering the Commission to order restitution in administrative cases. The Act already affords customers three separate methods to seek redress--private rights of action in federal court, the Commission's reparations program and exchange and futures association arbitration; in addition the Commission can and does seek disgorgement where appropriate in injunctive cases in federal district court. The Commission believes that customers would be better advised to move promptly to utilize one of the broad range of existing remedies the Act provides to seek damages at the outset of their claim rather than await the outcome of a Commission investigation and administrative trial. And even if there is an administrative action, there is no assurance that there will be funds available for the customers at the conclusion of the case. Thus, this provision could in fact delay the recovery of damages by customers.

In this regard, we note that the Commission already seeks disgorgement of unlawful profits for payment to customers in district court enforcement cases. We have been successful in seeking restitution in these injunctive actions because they can be prosecuted more quickly than administrative cases. Even here, however, the size of customers'

recovery rarely approaches the amount of wrongdoers collected during the course of the unlawful activity.

The Commission does not believe the establishment of a "class action" option in reparations is necessary.

Typically, a class action requires that common issues predominate over the class members' individual claims. The vast majority of reparation complainants bring their claims under anti-fraud provisions of the Act and Commission rules. Generally, these types of claims would not qualify for class action treatment because they depend upon unique, fact-intensive, circumstances, such as the particular futures contract or other instrument involved, the relative financial sophistication of the customer, the particular representations made by a respondent, and the degree of the complainant's reliance on those representations. Moreover, even if there should be a factual issue common to the claims of several reparations complainants, the opportunity for class certification would provide little advantage in these cases because each individual fraud claim would still have to be evaluated in any event.

The Commission would support report language encouraging an evaluation of the reparation program to ensure it is meeting its Congressionally mandated goals and to recommend improvements if necessary.

S. 1729 also adds a proposed section 9(h) to the Act that would make it a felony to willfully violate any provision of the Act or a Commission rule or to make false statements in documents required to be filed with the Commission or in applications for membership in a contract market or futures association. The Commission believes that the breadth of this new section, which parallels a key provision of the federal securities laws, may enhance the Commission's ability to interest U.S. Attorneys in initiating criminal prosecutions for violations of law. We would point out, however, that section 9(h) may conflict with the various subsections of existing section 9 which differentiate between violations of specific sections of the Act and regulations by making some misdemeanors and others felonies. For example, under the bill all knowing violations of Commission rules would become felonies, even if they involve missing reporting deadlines or minor infractions of recordkeeping requirements. We query whether the Committee intends S. 1729 to override or to complement existing law and suggest that clarification be provided by the Committee.

Finally, we have some concern over the intent and potential impact of the amendment made by the

bill to section 4b, the Act's principal antifraud provision governing futures trading. Based upon our experience using 4b to combat fraud, it is our belief that this increased prospect of liability could have a significant impact upon the operations of brokerage firms and other industry professionals. Section 601 of the bill would add a new subparagraph (E) to section 4b that would prohibit any person, acting for or on behalf of any other person, from engaging in any practice or course of business that would operate as a fraud or deceit on any person or to employ any device or scheme to defraud any person. Under existing law the reach of the prohibitions in section 4b is directed to acts or omissions harming the person on whose behalf the wrongdoer is acting. Thus, for example, a customer may sue a broker for false statements in connection with the customer's futures trading. Under the bill it also would be a violation if such false statements operated as a fraud upon any person other than, or in addition to, the customer, even if the other person had no business or other relationship to the wrongdoer. Further, in contrast to other subparagraphs in section 4b, the language of subparagraph (E) appears modeled on that of section 4o of the Act, which some courts have held does not include a scienter requirement to establish liability.

Thus, section 601 may be read as eliminating both the need to establish the fiduciary relationship between a plaintiff and the wrongdoer and a scienter requirement. If so read, for example, persons who negligently report prices off the trading floor could be charged with fraud by a third party. If the Committee proceeds with this proposal, we would recommend at a minimum that it make clear that the new subparagraph (E) includes a scienter requirement that parallels the other provisions of section 4b.

Assistance to Foreign Futures Authorities

S. 1729 includes our proposal that would permit the Commission to conduct investigations upon the request of a foreign futures authority without regard to whether the facts stated in the request constitute a violation of U.S. law. The Commission believes that this authority is needed to help obtain reciprocal investigative assistance from foreign authorities. Such assistance would be a powerful tool in effectively enforcing the Commodity Exchange Act in investigations that require the gathering of information from foreign sources. The proposed investigative authority closely parallels the authority obtained by the Securities and Exchange

Commission last year in section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988.

We are very concerned, however, about the absence from the bill of our proposed amendment and conforming changes to protect from compelled disclosure confidential information provided to the Commission by foreign futures authorities. This language is critically important to the Commission's ability to obtain full cooperation in enforcement matters from these authorities. The Commission's foreign counterparts are very concerned about the possibility that confidential information which they provide to the Commission might be disclosed to third parties, either through the Freedom of Information Act, or via third-party subpoenas. There are no parallels to these types of disclosure under the laws of many foreign jurisdictions. Indeed, the Commission has been advised that the laws of some foreign jurisdictions would preclude their authorities from entering into information-sharing agreements unless they could be assured that protections of confidentiality similar to theirs are available.

As you know, Section 8 of the Act already protects certain categories of information from public disclosure and reflects the particular sensitivity of Congress to the need to protect confidential information in the possession of the Commission. Recognizing and accommodating the concerns of foreign authorities about confidential information they provide to the Commission is consistent with that historical concern, and would further enforcement of the Act through full cooperation with foreign futures authorities. Moreover, H.R. 1396, the International Securities Enforcement Act of 1989, passed by the House, and S. 1712, the Securities Acts Amendments of 1989, reported by the Senate Banking Committee, each contain provisions similar to the Commission's proposal regarding the protection of information obtained from foreign regulators. Accordingly, we urge the Committee to add our proposed language to S. 1729 so that it will parallel this SEC legislation as well as the Commission's reauthorization legislation passed by the House in H.R. 2869.

Undercover Operations and Enforcement

S. 1729 empowers the Commission to conduct limited undercover investigations if the Attorney General has declined to do so after a request from the Commission. We think the indictments and Commission administrative actions announced this year have demonstrated the success of our ongoing

cooperative law enforcement efforts with other agencies, including participation in undercover operations. While we are pleased that S. 1729 recognizes the importance of these efforts, the Commission does not believe it appropriate to have its own authority to conduct undercover operations. We know of no other financial regulatory agency that has such power, and we believe it to be properly vested in the Federal Bureau of Investigation which has the training and resources to engage in this activity in all sectors of the economy while being exempt from certain laws. Accordingly, we prefer an approach taken which specifies that the Commission may continue to request the assistance of and cooperate with other agencies in conducting its investigations, including participation in the undercover activities of those agencies.

Access by GAO to information maintained by self-regulatory organizations

S. 1729 would empower the Comptroller General to have direct access to all recorded information and property in the possession of self-regulatory organizations under the Act and to information or property related to computer services in the possession of firms that provide these services to these organizations or to the Commission. The Comptroller General would be required to accord this information the same level of confidentiality as information obtained by the Commission.

We question the need for this provision. Except in the case of contractors or recipients of federal funds, GAO access to private sector records and data is traditionally accomplished through the oversight agencies, as it now is under the Commodity Exchange Act. To our knowledge, in its many audits and reports over the years on the Commission's regulatory activities, GAO regularly has been able to obtain industry data on a timely basis, either through access to information already in our possession or by our making a special request for the data at the behest of GAO. In our experience, these existing procedures have worked well and strike an appropriate balance between the needs of GAO and the protection of sensitive and confidential information from unnecessary and duplicative demands from multiple overseers.

Hiring and Compensation Authority of Commission

We support removing Commission personnel from the government-wide salary and classification limitations contained in Title 5 of the U.S. Code. We understand that the effect of this legislation is to permit the Commission to pay its employees above

the levels set for other personnel in the same job classifications and to do so on a basis comparable to the banking agencies. We understand also that similar legislation may soon be introduced to cover employees of the Securities and Exchange Commission.

It has become increasingly difficult for us to recruit and retain personnel for government service, particularly in the financial centers around the country in which the Commission has offices. The effect of this proposal would enhance the Commission's ability to do so and to keep pace with the recruitment efforts of the other financial regulators.

Service fees

We support imposing additional fees to reflect the cost of monitoring trading, supervising exchanges and of other services rendered and functions performed by the Commission.

Appeals by registered futures associations

S. 1729 would permit a registered futures association to appeal to a federal Circuit Court a Commission decision in an appeal from an association disciplinary action. The Commission opposes this change in existing law. In December 1985, as part of its report on the National Futures Association under Section 237 of the Futures Trading Act of 1982, the Commission proposed to Congress that only respondents in association disciplinary actions should have the right to appeal Commission decisions reviewing their cases. Subsequently, the NFA testified before this Committee in support of this refinement in the appellate process, and Congress enacted this concept into law as part of the Futures Trading Act of 1986. The Commission sees no reason to disturb that provision of the law.

Registered futures associations exist only because Congress provided enabling authority for their creation in 1974. Further, while the Commission remains extremely supportive of the NFA, some of its unique aspects, such as mandatory membership, dictate that the Commission exercise its oversight responsibilities with extreme care. The ability of a respondent to appeal an NFA disciplinary sanction to the Commission was intended as protection for the respondent, a vital protection in light of the requirement of mandatory membership. The NFA itself does not need such protection because, other than the possibility of reversal or having a case remanded, the NFA does not face any adverse legal consequences when its decisions are overruled. Finally, since in many ways NFA is acting on behalf of the government's interest in enforcing rules and

practices required by the Act, allowing NFA to appeal an adverse Commission decision in disciplinary matters is somewhat akin to authorizing the Commission's own Division of Enforcement to appeal adverse Commission decisions in enforcement cases.

Telemarketing fraud

S. 1729 limits its focus on telemarketing to members of futures associations against whom some disciplinary action has been taken. In our view, such standards should not be focused only on firms against which a futures association has exercised its prosecutorial discretion. As explained in our submission proposing an alternative approach, we believe the scope of this provision should be broadened to empower the Commission to set standards throughout the industry concerning solicitation of new accounts by telephone. These standards could be designed to assure that there were appropriate procedures in place at all firms. These procedures might prevent conduct requiring a member responsibility action. Further, standards of general applicability would be more consistent with the Act's policy of encouraging the least anticompetitive regulatory action.

Study of delivery points for agricultural commodity contracts

The Commission supports this provision.

Authorization of Appropriations

We support the five-year appropriations authority and funding levels set forth in S. 1729. The levels of funding contained in the bill would allow the Commission to experience about a 35 percent real growth in staff levels over the pending level of 555 staff years. We also appreciate Chairman Leahy's statements that the Commodity Futures Trading Commission is today a permanent agency. Permanent authorization is consistent with regular and active Congressional oversight of the agency which the Commission has always supported.



U.S. Department of Justice

United States Attorney
Northern District of Illinois

United States Courthouse
Chicago, Illinois 60604

February 2, 1989

Ms. Wendy L. Gramm
Chairperson
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Ms. Gramm:

On behalf of the Federal Bureau of Investigation and my office, I want to take this opportunity to again thank you for your support of the Grand Jury investigation of illegal floor trading practices.

As you know, prior to undertaking the investigation, we sought the assistance and expertise of your agency. Without the assistance and counsel of your agency, this investigation would not have been possible. The men and women of your agency are to be commended for their invaluable and continuing assistance in this investigation.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Anton R. Valukas".

ANTON R. VALUKAS
United States Attorney

ARV/ej

Remarks of

Wendy L. Gramm
Chairman, Commodity Futures Trading Commission

Twelfth Annual Commodities Law Institute
IIT/Chicago-Kent College of Law
October 12, 1989

Economists are often called upon to make predictions. As you are no doubt aware, many of our predictions turn out to be wrong. There is, however, one historical truism that we can confidently rely upon in forecasting--crises and scandals breed government regulation.

Keep this thought in mind as you consider some events of the past year. First, there was the undercover investigation of trading on the floors of the Chicago exchanges. Then there was the emergency declared by the CBT in the July soybean futures contract. All of this within the context of an ongoing reauthorization process. The regulatory response to these events is important to the industry. In the upcoming year, the future of the futures industry will be written, for better or for worse, in Washington, not in Chicago or New York. Hopefully, it will be for the better.

The industry and the Commission are under more public and Congressional scrutiny than ever before. Had the investigation or the soybean emergency occurred during any other time, our burden would have been great enough. But coinciding with the

reauthorization process, the level of scrutiny from Congress and critics has reached unprecedented levels. Congress has held numerous hearings this year reviewing the performance of the industry and the CFTC, while the General Accounting Office has conducted nine different reviews. This time the challenge facing the industry is greater than it ever has been--greater even than it was after the market crash--for now the very legitimacy and integrity of the markets are being challenged.

At the Commission, we welcome Congressional oversight of our performance, and in recent years we have had the benefit of extensive scrutiny. Such oversight is often a positive force. Weaknesses in the regulatory system can be revealed, and reforms provided to address those weaknesses. As the events of this year demonstrate, some regulatory and statutory changes are needed and reform measures will be adopted. The Commission will work with Congress to assure that these reform measures are well targeted, addressing real issues facing the industry.

CONGRESSIONAL ACTIONS

Many on Capitol Hill are calling for more direct regulation by Congress and the Commission. Both houses of Congress appear to be in favor of imposing important new restrictions on the exchanges and on certain trading practices as well as expanding CFTC authority and oversight. Let me highlight some of the

regulatory changes that have either been adopted in the House or are currently being considered in the Senate.

The U.S. House of Representatives has unanimously approved H.R. 2869, a strong bill designed to maintain the integrity of futures market and protect the public interest. The Commission supports the general goals of this bill and most of the specific provisions. This bill includes (1) a prohibition on dual trading subject to some limited exceptions; (2) a requirement that the Commission continue to cooperate with other Federal law enforcement agencies in conducting undercover investigations; and (3) a requirement setting certain standards for and monitoring improvements to the audit trail. There are some elements proposed in the bill, however, that the Commission questions in terms of necessity and practicability. These questionable provisions include (1) the requirement that the Commission monitor and approve changes in margin levels on stock index futures, and (2) the requirements that the execution time of each trade be stated in 30-second increments.

This past week the Committee on Agriculture of the U.S. Senate proposed the Futures Trading Practices Act of 1989. The Commission also supports the general goals of this legislation. The bill includes major provisions that (1) require each futures exchange, within three years, to implement new audit trail systems capable of capturing transaction times in a precise, independent and complete manner; (2) require the Commission to assess on a two-year cycle the trade monitoring systems of each

exchange to determine its capacity and effectiveness in detecting and deterring violations and issue an interim order specifying a timetable for corrective actions if these systems fail to meet the standards laid out in the bill; and (3) ban dual trading unless the Commission finds that an exchange trade monitoring system fully satisfies the audit trail standards set in the bill.

The Commission is committed to working with the Senate to make this bill as effective and workable as possible. We will work in the same fashion with both the House and the Senate as they go into conference to produce a final bill. The Commission wants to see a tough and effective reform bill passed this year.

Although many of you did not know me before I came to the Commission 18 months ago, I think many of you have become familiar with my views -- that these futures markets have been at the cutting edge in financial market innovation in this country and around the world -- developing new products to meet the hedging needs of commercial enterprise and innovations in trading technology.

You have heard me argue about the benefits of self-regulation, for example, in margin setting and in trade clearing and settlement. You have heard me extol the virtues of innovation motivated by market forces and vigorous competition. When asked about Globex and open outcry, I've always said that the markets

and competition would determine if open outcry in the pits would coexist with a screen trading system or be replaced by one.

However, it is increasingly clear that competitive market forces will not be the only or even the most important determinant of outcomes--and that self-regulation as it exists will be forever changed. Exactly how much of the self-regulatory structure will be allowed to exist depends on industry, exchange, and Commission response to the call for reforms -- that is, how seriously we take the call for reforms. The Commission for its part, believes serious reforms are needed now.

COMMISSION ACTIONS

Let me preface my discussion of the Commission's response by noting that the Commission has long held that effective law enforcement requires cooperative actions with other agencies, including criminal prosecutions at the federal, state and even local level. The criminal investigation in Chicago is an example of an innovative enforcement effort based on cooperation between the CFTC, the Department of Justice, and the FBI. Cooperation with other law enforcement agencies and the FBI will continue and is continuing. If I've said it once I've said it 100 times: the Commission will use all available tools to root out fraud and abuse. These markets are too important to let those who violate the law prevail.

In August, we proposed new rules to better deter the types of abuse that were alleged in the indictments and in the Commission settlements stemming from the undercover investigation in Chicago. These rules are targeted at specific problem areas and are measured and appropriate responses to the abuses revealed by the investigation. The proposed rules are intended to improve the accuracy and reliability of audit trail data and inhibit the ability of traders to alter records. They also will help control abuses related to out trades and kerb trading and increase the monitoring of opening and closing markets.

The most important of these proposed rules concerns the effort to improve the reliability of audit trail data and to inhibit falsification of records. Both Congress, the Commission and GAO agree that the audit trail can be improved. We differ on exactly how and what to do. The Commissions' proposed amendments would tighten requirements on the use and collection of trading cards to prevent traders from manipulating their trading records. In addition, trading cards would be collected more frequently in the pits, ultimately every 15 minutes. The Commission also (1) established a pilot program to increase its floor surveillance presence and (2) proposed a rule to prohibit persons with significant disciplinary histories from seeking election or serving on exchange or NFA boards or committees.

The Commission is concluding its study on dual trading. The study takes a careful look at the extent of dual trading and

tests some hypotheses concerning the benefits of dual trading. The Commission will be releasing the study shortly.

We also are completing a study on broker associations. We believe it is important to identify members of various broker associations and use this information in surveillance and compliance programs. Our rulemaking concerning broker associations should be completed later this fall.

While many of these proposals are far reaching -- there are important points for you to remember. Trading abuses did occur in these markets. Reforms must be made. You should not think that these reforms will be costless -- but they are essential if we are to maintain the integrity of these markets.

The Commission's response to the current crisis is clear. We have proposed reforms to better deter and detect abuse. Make no mistake such reforms will impose costs. My question to you is -- what's your response? Business as usual? We survived the aftermath of the crash and this too will pass? I don't think so. The industry needs to show those writing the reform agenda in Washington that they are prepared to act, and act decisively, to ensure market integrity. Only in this way can public confidence in these markets be maintained.

Senator HARKIN. I have an opening statement. I wasn't here at the beginning of the hearing. I will submit it for the record.⁴

What I will do now is call the next panel up for opening statements, and then we will recess until 2:30. Karsten Mahlmann, chairman of the board, Chicago Board of Trade; Leo Melamed, special counsel and chairman of the executive committee of the Chicago Mercantile Exchange; Z. Lou Guttman, chairman of the board of directors, New York Mercantile Exchange; Robert E. Fink, chairman, Commodity Exchange, Inc.

If those four could please come up to the witness table. Again, in consultation with Senator Lugar, we ask, if you could, that you each give your opening statement in around 5 minutes, then we'll all break for lunch and come back at 2:30. We will pick up the questioning at 2:30.

We will start in the order in which I read the names. The first will be Karsten Mahlmann, chairman of the board, Chicago Board of Trade.

I want to welcome all of you here today and thank you for your patience. As you can tell, this matter has generated a lot of interest. I have a feeling it's going to be a long day today for all of us.

Mr. Mahlmann, welcome and please proceed, if you can, for 5 minutes. If you feel that you want to add some things, perhaps when we come back at 2:30, we could do it at that time.

STATEMENT OF KARSTEN MAHLMANN, CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, IL

Mr. MAHLMANN. Senator, I will be within a minute of the 5-minute time. Thank you very much.

INTRODUCTION

Mr. Chairman and members of the committee, my name is Karsten Mahlmann. I am chairman of the Chicago Board of Trade. The Board of Trade has over 3,600 members who have been rocked this year by widely publicized allegations against 22 individuals. In all the attention paid to these 22 individuals, little or no attention has been given to the vast balance of our membership which has continued to carry out the vital business which is done each day and night on our exchange:—

A PRIME EXAMPLE OF OUR MEMBERS' CONTINUED PERFORMANCE OCCURRED SUNDAY EVENING

A prime example of our members' continued performance occurred Sunday evening. The Board of Trade's evening hours market, inaugurated 2 years ago to cover early morning trading hours in Japan, was the first worldwide market to open following last Friday's 190 point stock market drop. In an atmosphere of great international uncertainty, the 700 to 800 members standing in our trading pits Sunday evening handled a record volume of over 285,000 contracts, representing an underlying value of \$28 billion in U.S. Treasury debt, in a one-tick market. Worldwide investors were able to seek the security of the U.S. Treasury market

⁴ The prepared statement of Senator Harkin can be found on pp. 2-3.

Sunday night—quickly and efficiently—providing reassurance to investors all over the world and setting a tone of calm and orderliness which I believe influenced the operation of markets throughout the world yesterday.

OUR MARKETS ARE A NATIONAL ASSET

Our markets are a national asset. Any primary dealer participating in U.S. Treasury auctions before 1977 will state that the bid/ask spread for cash Treasury bonds before our Treasury bond futures market started was \$300. In 1989 when our bond volume soared to nearly 300,000 contracts per day, that spread is \$30.

WHAT DOES THIS MEAN?

Our markets allow the U.S. Government to market its debt more efficiently to primary dealers and more economically than ever. This service provides a major savings to U.S. taxpayers.

WORLDWIDE DEMAND FOR OUR SERVICES HAS ALSO GIVEN RISE TO UNPRECEDENTED AND DETERMINED COMPETITION FROM FOREIGN SOURCES

Worldwide demand for our services has also given rise to unprecedented and determined competition from foreign sources. On December 1 of this year, the Tokyo Stock Exchange will start trading a carbon-copy of our U.S. Treasury bond futures contract. Japanese investors already own 30 percent of the U.S. debt and, now, Japanese institutions will have their own U.S. Treasury bond contract which they can trade by their own rules to accompany this huge ownership in America. In effect, the Japanese will not only own our debt, but U.S. bond prices, and the interest rate that we pay, may be determined in Tokyo.

Please understand me: I do not mention foreign competition to suggest that we sacrifice U.S. market integrity in the interest of increased volume or lower costs. I mention it because, one, we deceive ourselves if we think we cannot lose this industry—overnight—to aggressive foreign competition; and, second, the irony would be that we would lose ground to markets that provide substantially less in the way of customer protection and market integrity than we in the United States provide.

WE RELY ON THE COMMITTEE'S SKILL AND MODERATION TO DRAFT LEGISLATION THAT PRESERVES OUR MARKETS' EFFICIENCY WHILE REINFORCING THEIR INTEGRITY

Like Senator Leahy said, and we corroborate, we want a "workable system that is honest, efficient, effective and fair." We rely on the committee's skill and moderation to draft legislation that preserves our markets' efficiency while reinforcing their integrity.

CHARGES TAKEN SERIOUSLY AND SHOULD NOT BE USED AS A FOUNDATION FOR IMPOSING AUDIT TRAIL STANDARDS

No one takes the charges that have been leveled in the recent grand jury indictments as seriously as do we, the leadership and members of the Chicago Board of Trade. But the worst outcome of this reauthorization process would be to use the indictments as a

foundation for imposing audit trail standards utterly incompatible with a liquid market or raising costs of access to our customers by imposing new and unwarranted taxes on our markets.

PROBLEMS WITH S. 1729

I fear the bill, as introduced, does both these things. First it requires trade timing by a source independent of the person making the trade. I will flatly state that our markets could not have performed as they did Sunday night if such a standard had been in place.

Second, the service fee provision also is problematic. At a time when the futures industry is shouldering the substantial cost of market reforms, a new CFTC fee that could be used to fund the agency's entire budget could constitute a crushing burden and a competitive handicap.

IMPROVING OUR MARKET SURVEILLANCE PROGRAM

In the past years, we have devoted a substantial percentage of Board of Trade staff and resources to improving our market surveillance program.

Since January of 1989, our surveillance budget has been increased by \$1.1 million to fund a major expansion of computerized audit programs to 100 percent, as opposed to 10 percent previously, of all trades. We have increased our surveillance staff by 30 percent. We have adjusted and submitted for CFTC rule approval measures that would tighten trading card submission schedules and eliminate practices or procedures that lead to even the suggestion of abuse.

We are now testing a computerized order entry system that times the entry of every customer order to the nearest second. We are also making steady progress on a broker work station that will further pinpoint the time of all order executions. Work on both projects is now at advanced stages.

As a major part of our enhancement of open outcry trading, we have joined with our major competitor, the Chicago Mercantile Exchange, to develop jointly at a cost of \$5 million, with significant additional implementation costs, a tamperproof, hand-held terminal which will electronically record each trade in an unimpeachable audit trail. Through our combined efforts, resources and determination, we and the Chicago Mercantile Exchange believe such a measure can be implemented in less than 3 years, thereby striving to meet the standards set by this committee—a feat that technology could not have foreseen for highly liquid markets even 2 years ago.

FOUR POINTS FOR THE COMMITTEE CONSIDERATION

Members of the committee, if I could leave you with four points, they would be:

First, we are currently better, more comprehensively regulated than any markets in the world.

Second, steps can be and are being taken substantially to enhance the level of market integrity without impairing market performance.

Third, we can lose this vital business which American enterprise and know-how have singlehandedly fostered.

Fourth, we want to work with you to continue to have the most honest, efficient and liquid markets in the world.

We ask only that the Congress employ a sense of balance in drafting its reauthorization measures and recognize that markets are delicate mechanisms, not to be regained once lost. Congress has the *power* to weaken our markets, but it has the *opportunity*—and we hope the wisdom—to preserve our markets' national value and to make them even stronger.

Thank you.

[The prepared statement and attachments of Mr. Mahlmann follow:]

TESTIMONY OF KARSTEN MAHLMANN
BEFORE THE SENATE AGRICULTURE COMMITTEE
OCTOBER 17, 1989

Mr. Chairman, Members of the Committee:

My name is Karsten Mahlmann and I am the elected chairman of the world's oldest and largest futures exchange, the Chicago Board of Trade. The Board of Trade has over 3,600 members who have been rocked this year by widely-publicized allegations that, to date, involve 22 individuals. Our members have had to carry on their business in the face of disturbing headlines and demoralizing publicity while the leadership of the Exchange has taken numerous positive steps, with their full endorsement, to respond to the issues raised by the investigation and accompanying indictments. In all the attention paid to these 22 individuals, little or no attention has been given to the vast balance of our membership which has continued to carry out the vital business which is done each day and night on our exchange.

A prime example of our members' continued performance occurred Sunday evening. The Board of Trade's evening hours market, inaugurated two years ago to cover early morning trading hours in Japan, was the first world-wide market to open following last Friday's 190 point stock market drop. In an atmosphere of great international uncertainty, the 700-800 members standing in our trading pits Sunday evening handled over 285,148 contracts, representing an underlying value of \$28 billion in U.S. Treasury debt, in a one-tick market. That is an unprecedented contract volume for our evening session. Typically, we trade approximately 15,000 contracts per night. Our greatest previous evening session volume was 101,141 contracts traded the night of October 19, 1987, the date of the '87 Stock Market Crash. World-wide investors were able to seek the security of the U.S. Treasury market Sunday night--quickly and efficiently--thanks to the competence and composure of our members. Doing business under extraordinary circumstances, they provided reassurance to investors all over the world and set a tone of calm and orderliness which has hopefully influenced the operation of markets throughout the world.

Gentlemen, our markets are a national asset. They provide the lubricant for financial transactions around the world. Just ask any primary dealer who participated in U.S. Treasury auctions before 1977, what was the bid/ask spread for Cash Treasury Bonds before our Treasury Bond futures market started trading. He'll tell you \$300. What about in 1989 when our bond volume soared to nearly 300,000 contracts per day? He'll tell you \$30.

What does this mean? Our markets allow the U.S. government to market its debt more efficiently and more economically than it has ever done. This service provides a major savings to the U.S.

taxpayer. The growth in trading volume and use of Treasury bond futures corresponds with a growth in the federal debt from \$700 billion in 1977 to over \$2.3 trillion currently. The primary dealers underwriting the Treasury's debt issuances, and the institutions and individuals that trade this debt and take it into their inventories, need a cost effective way to manage the risks they face. The Treasury bond futures market provides the needed cost-effective risk management vehicle.

Depository institutions use Treasury bond futures to adjust the risk exposure of their asset/liability mix. Portfolio managers hedge their income-earning assets with Treasury bond futures. The list of users and applications goes on and on. In just over ten years the Treasury bond futures market at the CBOT has come to epitomize the value of financial futures to the United States economy.

Chicago is the capital of world futures trading. This is an acknowledged fact. Chicago has taught the world the value--the necessity--of futures trading. And, for that reason, our volume has grown to tremendous levels over the last 10 to 15 years. Even in this difficult year, U.S. futures exchanges' volume figures are at historic levels.

Worldwide demand for our services has also given rise to unprecedented and determined competition from foreign sources. On December 1 of this year, the Tokyo Stock Exchange will start trading a carbon-copy of our U.S. Treasury Bond futures contract. Japanese investors already own over 30% of U.S. debt and, now, Japanese institutions will have their own U.S. Treasury Bond contract which they can trade by their own rules to accompany this huge ownership in America. In effect, the Japanese will not only own our debt, but U.S. bond prices may be determined in Japan instead of the U.S.

The Japanese are only the latest in a long line of competitors for Treasury Bond futures business. I specifically mention them because--as the U.S. has learned from experience--they are formidable competitors. Their government also has made no secret of its interest in taking any and all measures necessary to make its futures markets succeed and predominate.

Please understand me: I do not mention foreign competition to suggest that we sacrifice U.S. market integrity in the interest of increased volume or lower costs. I mention it because 1) we deceive ourselves if we think we cannot lose this industry--overnight--to aggressive foreign competition, and 2) the irony would be that we would lose ground to markets that provide substantially less in the way of customer protection and market integrity than we in the U.S. provide.

Currently, the level of futures trading regulation is substantially greater in this country than anywhere else in the world. At the same time, we have opened our markets to foreign competition. In 1987, the CFTC adopted rules that would exempt those who offer foreign futures and options to U.S. customers from

complying with U.S. standards and requirements if the CFTC finds they are subject to a "comparable regulatory" program in their home country. Less than two years later, U.K. brokers offering the products of a U.K. exchange whose recent history has featured default and customer losses of a magnitude unknown in the U.S. are seeking relief from that "comparability" requirement. They are mounting a full court press to obtain this additional exemption because U.K. standards simply don't meet U.S. standards in certain key regulatory areas. And, if we're not careful, they might succeed.

These developments are most ominous. As I appear before you today, I am well aware that this body literally has the power to irrevocably alter the dynamics of our markets. I view this point at which we stand as a watershed--two to five years from now we can either look back upon this as a period in which market mechanisms and meaningful reforms were melded carefully to strengthen U.S. markets or hammered together in such a way as to demolish them. It is a critical juncture.

Like you, Senator Leahy, we want a "workable system that is efficient, effective and fair." We rely on the Committee's skill and moderation to draft legislation that preserves our markets' efficiency while reinforcing their integrity.

No one takes the charges that have been leveled in the recent Grand Jury indictments as seriously as do we, the leadership and members of the Chicago Board of Trade. The charges and media attention have struck at the heart of the 3,600 men and women who, like me, consider their membership in our Exchange their proudest asset. But the worst outcome of this reauthorization process would be to use the indictments as a foundation for imposing audit trail standards utterly incompatible with a liquid market or raising costs of access to our customers by imposing new and unwarranted taxes on our markets.

I fear the bill, as introduced, does both these things. First it requires trade timing by a source independent of the person making the trade. That can only be done by making our markets less efficient than those of our competitors. The trader must play a role in timing the trade, whether it is writing on a card, or key-punching an electronic device. True independence is an unattainable standard which serves no purpose. I will flatly state that our markets could not have performed as they did Sunday night if such a standard had been in place.

Second, the service fee provision also is problematic. At a time when the futures industry is shouldering the substantial cost of market reforms, a new CFTC fee that could be used to fund the agency's entire budget could constitute a crushing burden and competitive handicap.

We know the Senate must consider ways of reinforcing market integrity in times such as these. We are true allies in such an effort. In the past years, we have devoted a substantial percentage of Board of Trade staff and resources to improving our market surveillance program. And these efforts have received

unprecedented emphasis in the months following the announcements of the U.S. Attorney's investigation.

Our surveillance budget has been increased by 1.1 million dollars to fund a major expansion of computerized audit programs to 100% (as opposed to 10% previously) of all trades. We have increased our surveillance staff by 30%. We have adjusted and submitted for CFTC rule approval measures that would tighten trading card submission schedules and eliminate practices or procedures that lead to even the suggestion of abuse.

We are now testing an automated order entry system that times the entry of every customer order to the nearest second. And we are also making steady progress on a broker work station that will further pinpoint the time of all order executions. Work on both projects is now at advanced stages.

In regard to computerized trading, we have developed the Aurora system. We plan expeditiously to initiate this after-hours electronic market. Don't misunderstand me. By attempting to trade futures electronically, we are not abandoning open outcry at all. Open outcry trading offers an unequalled trading system that we are working to perfect. Substituting yet untested computerized or electronic trading methods for open outcry now would be most imprudent, as the London experience after Big Bang shows. Open outcry is the reason our markets remain the center of risk management for the world. It is what differentiates our markets from foreign markets. Foreign markets have never been able to foster successful open outcry markets; for that reason, they have turned to the computer--a ground on which they can compete. Foreign markets will never be able to beat us if we preserve what we do best.

As a major part of our enhancement of open outcry trading, we have joined with our major U.S. competitor, the Chicago Mercantile Exchange, to develop jointly at a cost of \$5 million (with significant additional implementation costs), a tamper-proof hand-held terminal which will electronically record each trade in an unimpeachable audit trail. Through our combined efforts, resources and determination, we and the CME believe such a measure can be implemented in less than three years, thereby meeting the standards set by this Committee--a feat that technology could not have foreseen for highly liquid markets even two years ago.

We believe we have implemented and will, in a remarkably brief time span implement, sweeping, historic and dramatic changes in the surveillance systems that buttress our markets. We believe we can accomplish this goal without destroying our markets' unrivaled liquidity or driving U.S. customers abroad to less regulated marketplaces. It will be a financially costly undertaking, but it will not cost us this U.S. market as we fear some of the proposals currently in S. 1729 would do. It will tax us, but, unlike certain provisions of the current legislative proposal, it will not impose a tax that will drive our customers overseas.

Members of the Committee, if I could leave you with four points, they would be that 1) we are currently better, more comprehensively regulated than any markets in the world, 2) steps can be and are being taken substantially to enhance the level of market integrity without impairing market performance, 3) we can lose this vital business which American enterprise and know-how have single-handedly fostered, and 4) we want to work with you to continue to have the most honest, efficient and liquid markets in the world.

We ask only that the Congress employ a sense of balance in drafting its Reauthorization measures and recognize that markets are delicate mechanisms, not to be regained once lost. Congress has the power to weaken our markets, but it has the opportunity--and we hope the wisdom--to preserve our markets' national value and to make them even stronger.

Thank you very much. Detailed written testimony which I submit for the record supplements my statement and provides our provision--by--provision analysis of the Committee's draft bill. Thank you for considering it.

Additional questions to be submitted to the record for the CFTC reauthorization hearings on Oct. 17 and 18.

By Senator KENT CONRAD

Questions for Karsten Mahlmann, Chairman of the Board, Chicago Board of Trade:

I have some additional questions. The first group can clarify my understanding of the Soybean emergency this summer:

1. When exactly did the Chicago Board of Trade (CBOT) ask Ferruzzi to begin selling soybean contracts? Was Ferruzzi asked to begin selling on July 5?
2. Did Ferruzzi began selling when the CBOT asked them to sell? Was this on July 5?
3. Could the CBOT ordered liquidation have caused the price to begin falling? Could the initial price fall have lead to panic selling later on in August?
4. Did traders who could not deliver July contract soybeans ask the CBOT to issue the emergency order?
5. Did Ferruzzi take delivery of 6.5 million bushels of May contract soybeans? Did the CBOT ask Ferruzzi to sell soybean contracts in May? If not, why not?
6. When did the CBOT know the amount of deliverable soybeans in July? Was this known by July 5? Why was the emergency order given on July 11 when it appears that the CBOT knew about the potential problem earlier?
7. What would have happened to traders holding short positions if the emergency order had not been issued?
8. What kind of changes in legislation and CFTC regulation would be helpful in preventing repeats of the July soybean emergency? Would any of the provisions in the House or Senate bills have helped in this regard?

Concerning the development of audit trail technology:

1. Smaller exchanges have said that they would have difficulties developing and/or implementing electronic systems that would improve the audit trail. The CBOT has said that it would share any technology developed. Is that true? Under what conditions would you share the technology? What kinds of costs would you expect the smaller exchanges meet in implementing shared technology?
2. Will your development of this new technology take into account the needs of smaller exchanges? Could their concerns and needs be somehow taken into account in the development phase?

RESPONSE OF THE BOARD OF TRADE OF THE
CITY OF CHICAGO TO THE ADDITIONAL QUESTIONS SUBMITTED
FOR THE RECORD BY SENATOR KENT CONRAD

JULY SOYBEAN EMERGENCY ACTION

Much discussion - and also unfortunately, much misinformation -- has been generated by the July 11, 1989 Emergency Resolution of the Exchange's Board of Directors regarding the expiration of the July soybean contract. Ironically, much of the misunderstanding has arisen (often intentionally generated by special interests) as a result of a contract market performing the duties imposed upon it by an Act of Congress in total cooperation with its governmental agency for the benefit of the market's integrity. As reviews of the action have been completed, several facts are now clear:

- (1) The Exchange's action was taken in order to prevent the clear and present danger of a disorderly expiration and potential defaults in the July contract;
- (2) There was no disadvantage to farmer/producers in the prices available to them as a result of the order. At the time of the Board's action, farmers' soybeans were being priced based on the November -- not the July-contract;
- (3) The CFTC found that no conflict of interest of any sort was involved in the adoption of the emergency resolution; and
- (4) The principal market participant -- Ferruzzi -- has since been subject to at least two public class action civil lawsuits for market manipulation, one from long market participants and one from short market participants.

To fully understand the July 11, 1989 Board action, however, it may be useful to review the events that preceded the decision. Pages 46 - 51 of the Exchange's supplemental written submission details these events in a chronological summary. Additionally, we are pleased to submit the following specific responses.

Question Number One: When exactly did the Chicago Board of Trade (CBOT) ask Ferruzzi [sic] to begin selling soybean contracts? Was Ferruzzi [sic] asked to begin selling on July 5?

Response: Immediately after the May soybean futures contract expired, the Business Conduct Committee began contacting all major market participants, both long and short, to insure the orderly

liquidation of the July futures contract. Communication with both long and short participants continued throughout this period on a virtually constant basis (including several times during the trading days as market conditions evolved).

During the month of June, the Business Conduct Committee and staff of the Office of Investigations and Audits closely monitored both futures and cash market activity and expressed increasing concern over the developing circumstances. The Exchange also remained in communication with the CFTC throughout this time.

Specifically, a single market participant, Ferruzzi, held a large portion of the July futures open interest. This included a long position equivalent to 23 million bushels of soybeans and nearly all of the inventory of the registered soybean receipts for delivery at the Board of Trade. On numerous occasions, the Business Conduct Committee and the Office of Investigations and Audits held discussions with Ferruzzi regarding its market activity.

Multiple instances were identified by the staff of the Exchange where cash soybeans were available in several locations at the equivalent or less than the July futures price, thus signalling a situation in which the long participant would customarily liquidate its position. Similarly, during the month of June, major soybean users began pricing soybeans based on the August and November contracts -- both an extremely unusual situation and an additional indication of concern whether the July contract was effectively performing its economic function. Throughout this time no commercial customers registered complaints and concerns regarding the actions in the contract.

During the first week of July, Ferruzzi again appeared before the Business Conduct Committee to discuss its dominant position in the July futures contract, its large holding of registered receipts, and its cash market activities. At the conclusion of that July 5 meeting, the Business Conduct Committee directed Ferruzzi to reduce its position substantially or the Business Conduct Committee would request that the Board of Directors take emergency action to ensure the orderly liquidation of the July soybean contract. Subsequent to that meeting, Ferruzzi failed to reduce its positions in accordance with the Business Conduct Committee's direction.

Question Number Two: Did Ferruzzi began [sic] selling when the CBOT asked them to sell? Was this on July 5?

Response: No, Ferruzzi did not reduce its position as requested by the Business Conduct Committee.

In a July 10, 1989 response to the Business Conduct Committee's July 7 request to substantially reduce its long July position (which request formalized the instructions given Ferruzzi orally on July 5), Ferruzzi claimed that it was unable to discuss the

Committee's decision with its Group Managers throughout the world. (Nevertheless, Ferruzzi that same day liquidated large positions in other futures contracts.) Because Ferruzzi did not want its actions to "be construed by the market as being overly aggressive, ... artificial and manipulative," it refused to comply with the Committee's request and instead threatened to "use any means at its disposal to recover all damages incurred due to such action."

As a result of Ferruzzi's failure to reduce its holdings, the Business Conduct Committee recommended to the Board of Directors that the Board exercise its emergency authority to ensure the orderly liquidation of the July soybean contract. Furthermore, as part of the CFTC's market surveillance activities in monitoring the July liquidation, the Commission sent a letter on July 11 to Ferruzzi informing it that the Commission would not consider any positions held as anticipatory hedges to be bona fide hedges as of July 18, 1989.

Question Number Three: Could the CBOT ordered liquidation have caused the price to begin falling? Could the initial price fall have lead to panic selling later on in August?

Response: Initially, an analysis of soybean futures prices shows that prices began to decline well in advance of the Board's orderly liquidation resolution. The CFTC's review and analysis confirms that this decline was due to natural market forces, not any Exchange action.

The CFTC expressly found that the emergency action is not likely to have any significant or long-term impact on the price of soybeans to producers or consumers because most cash prices were already being priced off the November futures contract at the time of the action and because the action did not alter the fundamental demand for soybeans. Furthermore, the sharp drop in prices for new crop futures after July 14, 1989 was in response to beneficial rains in U.S. soybean growing areas and to favorable supply developments in Brazil.

With respect to the August "panic selling", we are unaware of any market activity which could be so characterized.

Question Number Four: Did traders who could not deliver July contract soybeans ask the CBOT to issue the emergency order?

Response: No. The Board took its action without any request from traders to protect their positions. The Board took its action to insure the integrity of the marketplace for all market users, producers and consumers, longs and shorts alike.

Question Number Five: Did Ferruzzi take delivery of 6.5 million bushels of May contract soybeans? Did the CBOT ask Ferruzzi to sell soybean contracts in May? If not, why not?

Response: The May soybean expiration involved a very congested market. The Exchange's Business Conduct Committee was extremely active throughout the expiration with all major market participants. In the May expiration, all market participants - including Ferruzzi - responded to the Business Conduct Committee's market directions. That was clearly not the case in the July contract. Moreover, market conditions were different in May as detailed herein.

Regarding the precise amount of soybeans which Ferruzzi took through the contract delivery system in the May expiration, that information is nonpublic. However, should you need the precise figure, the CFTC can supply you with that precise information in a confidential manner.

Question Number Six: When did the CBOT know the amount of deliverable soybeans in July? Was this known by July 5? Why was the emergency order given on July 11 when it appears that the CBOT knew about the potential problem earlier?

Response: The Board of Trade was well aware of the status of deliverable soybean supplies throughout 1988-89, as it was of all relevant market conditions. The Exchange's concern was reflected in the Business Conduct Committee's continuous monitoring of expiring contracts and the constant communication with market participants.

The reason action was taken on July 11 rather than earlier is, first and foremost, the lack of responsive behavior from Ferruzzi as of July 10, 1989. Previously, Ferruzzi had responded to Business Conduct Committee requests and instructions; in July, they did not for the first time. This lack of responsiveness coupled with changes in market conditions beginning in June presented the factual predicate for the Board's July action.

Question Number Seven: What would have happened to traders holding short positions if the emergency order had not been issued?

Response: The Board's action was market neutral; it affected both longs and shorts alike. Absent the Board's action, traders holding short positions would have had to do exactly what they did: either offset their position or deliver soybeans per the contract's specifications. (The Board's July order effected only one short account position as of the date it was enacted.)

Question Number Eight: What kind of changes in legislation and CFTC regulation would be helpful in preventing repeats of the July soybean emergency? Would any of the provisions in the House or Senate bills have helped in this regard?

Response: Prior to its July action, the Board took emergency action in June to obtain authority co-equal with the CFTC's regarding speculative limit exemptions for certain agricultural futures contracts and also requested CFTC approval of the rule on

a permanent basis; the CFTC approved this emergency action as a permanent rule. The Exchange feels this will improve the ability to regulate the conduct of major market participants such as Ferruzzi in similar situations.

The Exchange does not feel that fulfilling its statutory mandate to insure fair, liquid markets and orderly liquidation requires "remedial" legislation. To the extent misperceptions of certain special interests in the marketplace raised questions concerning the propriety of the Exchange's conduct which were not thoroughly answered by the CFTC's report and analysis, the provisions of the Senate bill should more than adequately address their concerns.

Audit Trail Technology

Question Number One: Smaller exchanges have said that they would have difficulties developing and/or implementing electronic systems that would improve the audit trail. The CBOT has said that it would share any technology developed. Is that true? Under what conditions would you share the technology? What kinds of costs would you expect the smaller exchanges meet in implementing shared technology?

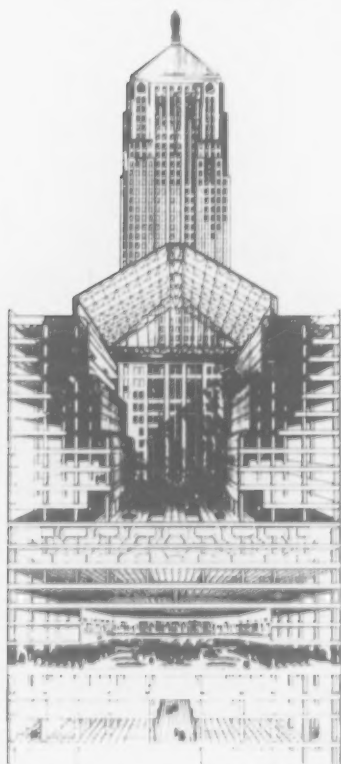
Response: Yes. As stated in testimony during the hearings before the Committee, we have offered to share this technology with other exchanges and we have already discussed this directly with several exchanges. The precise terms and conditions for such sharing will have to await developments regarding the research and creation of this technology. At a minimum, each exchange will have to incur its own costs relating to updated facilities, clearing mechanisms, etc. to use this yet-to-be-developed technology.

Question Number Two: Will your development of this new technology take into account the needs of smaller exchanges? Could their concerns and needs be somehow taken into account in the development phase?

Response: The development of this new technology will take into account the needs of the markets themselves including market participants and market users. These needs are common to all exchanges. Each exchange, large and small alike, likely will have to adopt the technology somewhat to its particular markets and memberships. We will be pleased to work with any exchange which requests input into the development phase.

Supplemental Submission
Before the Senate Committee on
Agriculture, Nutrition and Forestry

October 17, 1989



● Chicago Board of Trade

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EXECUTIVE SUMMARY

The Board of Trade of the City of Chicago ("CBOT" or "the Exchange") is the world's oldest and largest futures exchange, not only because CBOT markets are the most liquid, cost-efficient markets in the world, but also because of the Exchange's commitment to the highest degree of market integrity. Professional market user confidence in both the integrity and efficiency of CBOT markets is best demonstrated by the record volume which the Exchange has experienced each year for the last decade.

The Exchange does not now condone, and never has condoned, trading abuses of any kind. Founded on the concept of self-regulation, the Exchange has consistently policed and disciplined its own members. When floor trading abuses are detected and proven, the Exchange has always sanctioned violators appropriately, including the imposition of suspensions, fines and expulsions. The Exchange's commitment to preserving the utmost market integrity is undiminished today.

The cornerstone of market integrity is membership integrity. The Board of Trade has always maintained the highest standards of member qualification. As United States Attorney Anton Valukas recently asserted, "the best experts in the world concerning trading practices are the members of the Board of Trade."

Additionally, the Department of Investigations & Audit's ("OIA") use of the Computerized Trade Reconstruction System ("CTR") is a vital means of detecting rule violations thereby insuring market integrity. CTR is universally acknowledged to be the best audit trail in any of the world's financial marketplaces. Similarly, CTR-PLUS, the Exchange's surveillance system, is an unsurpassed system for the detection of potential market abuses. Indeed, the CTR-PLUS system highlighted as a potential abuse the trading activity of an apparent FBI agent trading as a member at the exchange, presumably pursuant to a federal investigation. As U.S. Attorney Valukas has acknowledged, the Board of Trade has "... the resources to identify trading practices in which fraud has occurred."

Regardless of this unparalleled record of success, the Exchange has consistently recognized that the process of improving its markets and surveillance systems is one of constant evolution. On an ongoing basis, the Exchange examines its market mechanisms and surveillance techniques to insure that it remains the world leader in this regard. This self-examination process has intensified recently in the wake of the sensationalized press reports of FBI and United States Attorney investigations into alleged trading floor abuses at the Chicago Mercantile Exchange and the Board of Trade and the forty six (46) recently announced indictments.

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The Exchange has recognized that continued public confidence in the marketplace requires an intensive review of market mechanisms as well as the surveillance and disciplinary processes. For the past several months, special exchange committees have engaged in detailed reviews and examinations of the Exchange's market structure and enforcement mechanisms. Those deliberations have resulted in reports to the Board of Directors. The Board, in turn, has approved numerous revisions in our market mechanisms and enforcement procedures. Those market enhancements are summarized below.

On October 5, 1989, Senator Patrick Leahy introduced S.1729, the Futures Trading Practices Act of 1989. The proposed legislation would make sweeping changes to several vital provisions of the Commodity Exchange Act ("CEA"). The Exchange supports the stated purpose of the bill to "design a workable system that is efficient, effective and fair." However, we are greatly concerned that in critical areas of the bill the precise methodology proposed to achieve that common objective may, at a minimum, render our domestic futures industry uncompetitive with ever increasing foreign markets and potentially destroy market liquidity. The proposals regarding requisite audit trail requirements, service fees and conflicts of interest are particularly crucial and require a modified approach.

Audit Trails and Broker (Dual) Trading

Permitting floor brokers in the futures industry to trade for their own account while also executing customer orders recently has come into question. Despite the fact that there have been no indications that any federal investigation or indictments are founded on alleged broker trading abuses, and despite the fact that the CTR-PLUS system is specifically programmed to detect (*inter alia*) any broker trading ahead of a customer's order, a few have questioned whether this practice is in the best interest of the marketplace.

First, broker trading is not unique to futures markets. Trading for one's own account while handling customer orders is a common practice in all financial markets; specialists and securities firms universally trade for their own account while executing customer orders.

Second, Congress, the CFTC and the futures industry have studied broker trading many times in the past decades. In each instance, the results overwhelmingly indicate that the ability of floor brokers to provide additional liquidity to the market by trading for their personal accounts is a valuable and necessary part of the marketplace. Preliminary Exchange data indicates that broker trading provides from 25-80% of futures market liquidity at

the CBOT. The Exchange strongly believes that any potential abuses of dual trading can be and are detected by current surveillance systems. Therefore, the Exchange feels that the elimination of broker trading would seriously impair market liquidity while serving no useful market purpose.

Richard Fogel, Assistant Comptroller General of GAO, has stated recently:

Banning dual trading doesn't really solve the problem of trading abuses... Restrictions on dual trading are no substitute for precise, complete and independent timing of trades. "Futures Trading, Leahy to Push for Tougher Exchange Audit Trail," Daily Report for Executives, September 11, 1989, p.A-8.

We agree. The focus should be on excellent audit trails.

The United States futures markets presently have the best audit trail and computer surveillance systems in any marketplace, foreign or domestic. Improvements can be -- and are being -- made. However, mandating unattainable standards will serve no one's best interest. This is especially true given that the Chicago Board of Trade and the Chicago Mercantile Exchange have agreed to combine their vast technological resources and dedicate five (5) million dollars to create a hand-held trading device ("AUDIT") which will promptly and precisely capture trade execution times thereby enhancing the already excellent audit trail. However, though we are optimistic of success, there is no guarantee that technology can be achieved in the near future which will not impair the efficiency and effectiveness of United States markets.

Therefore, the Senate Committee should consider technical modifications to the statutory language which will insure audit trail improvement without implicitly dictating standards which can only be met by a trading terminal not yet invented or automated trading systems. For despite the promise of automated systems, they cannot match the open outcry auction market system in use today in U.S. futures markets.

The Open Outcry Auction System

Many of the current discussions relating to futures markets deal directly or indirectly with the open outcry auction trading system which has been used in the U.S. markets for over 140 years. Under the open outcry system, traders congregate in a "pit" to engage in highly competitive negotiation of the futures prices of soybeans, Treasury bonds, stock indices, gold and numerous other products. The resulting competitive auction provides users to futures markets with fast, low-cost transaction services they need plus an open, transparent market environment which permits market abuse to be readily detected.

Recent discussions have focused on the advantages of automated trading alternatives to this system, despite the lack of success of automated futures trading to date, the difficulties experienced by automated equities market trading systems and the inability to monitor traders using these "upstairs" systems as closely as the traders operating publicly in the open outcry market. Much of the debate appears to be based on conjecture, rather than on evidence concerning the performance of open outcry auction or automated systems.

The open auction outcry system is an integral part of the process by which our futures markets have provided high quality prices and transaction services over such a long period of time. The open outcry system is a primary reason for the successful achievement of these quality prices and services because of its competitive environment and particularly because of the immediacy of execution provided. The efficiencies of open outcry have been attested to by staff members of the Federal Reserve:

The scalpers [market makers] in the futures pits appear to perform their middleman function more smoothly than the dealers in the Treasury securities markets. The futures market is continuous: never is there a moment without a firm quote. Futures scalpers trade for a profit of one "tick" (1/32 in bonds, 1 basis point in bills), whereas most dealers trade for two ticks. [Emphasis added.] Arnold Kling, "Futures Markets and Transactions Costs," Financial Futures and Options in the U.S. Economy - A Study by the Staff of the Federal Reserve System, December 1986.

Thus, the open outcry auction trading system is essential to the provision of the high quality prices and transaction services needed by users. The dynamics of the open outcry auction are directly responsible for the high information content of futures prices. The auction process is transparent and open to public scrutiny, unlike the 'upstairs' markets used in some trading environments.

Notwithstanding this unequalled record of quality prices and services, some have questioned whether market users would be better served by computerized trading systems for futures. Experience has demonstrated that automated trading systems have failed and other trading systems have not met the quality criteria nearly as well as open outcry.

In the U.S., computerized futures markets have never succeeded. The International Futures Exchange, or INTEX, the first fully-automated trading system, began trading in 1985; the

contract and the exchange ceased trading in 1988. In the words of INTEX's President, computerized futures trading failed because open outcry is the most efficient way to run a market and the electronic marketplace is unable to equal the market liquidity provided by open outcry. (Financial Times, October 23, 1987, p. 34).

Internationally, foreign exchanges have also experienced difficulties in the introduction of increased automation in their trading systems. In 1986, after London's "Big Bang", the Stock Exchange Automated Quotation (SEAO) system was introduced, effectively moving all trading off the floor of the ISE and onto the SEAO screen. However, institution of the automated system reportedly has resulted in the largest users of the market refusing to use it and creating "ad hoc markets".

Thus, "automated" trading systems often are unable to provide the liquidity, immediacy and continuity which users of U.S. futures markets have come to demand. Moreover, they operate out of public view, not subject to the same careful scrutiny which can be given to the open outcry auction system. Together, the difficulties experienced by automated trading systems to date, the lack of certainty regarding their capabilities and other potential pitfalls together dictate extreme caution in future experiments with automation.

The open outcry auction system itself is one of the U.S. futures industry's principal weapons against foreign competition. Each time a new futures product is introduced overseas, the goal is the same--to provide the same high quality price and transaction services as the U.S. futures markets, the world's standard. This high quality is directly related to the open outcry auction trading system. Altering this system would severely damage our competitiveness. Instead, the focus should be to improve and enhance the existing system, especially the audit trail.

Exchange Surveillance Systems Market Enhancements (Audit Trails)

As a result of the recent extensive reviews by select Committees, the Exchange has instituted numerous enhancements to the CTR and CTR-PLUS systems. The following enhancements and improvements have been approved:

- 1) The CTR-PLUS surveillance program has been expanded to analyze every trade made on the Exchange, rather than statistically selected samples.
- 2) A one million dollar fund for the further improvement of the CTR and CTR-Plus systems has been authorized.

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- 3) Trade time recordation brackets have been reduced from thirty (30) minutes to fifteen (15) minutes.
- 4) New five (5) minute time brackets have been approved for the opening and closing periods of trade when trading generally is heaviest.
- 5) The Exchange has enhanced trading card recordation requirements to now require that all trade cards must be accounted for; all trading cards must be collected and time-stamped hourly; and all trades must be submitted to the Clearing House within one hour of collection.
- 6) CTR-PLUS has been improved further by providing expanded surveillance tests, an expanded relational data base, and increased storage capacity.
- 7) The Exchange has required that all trading-floor-time stamp clocks be synchronized and accurate to within ten second intervals.
- 8) Additionally, five new computer programmers have been hired to support an extensive member/staff review and revision process of all surveillance systems.

Office of Investigation and Audits Enhancements

The Office of Investigations and Audits ("OIA"), the second largest department at the Exchange, has always maintained the highest level of professionalism and excellence. The high degree of professionalism exhibited by OIA has prompted U.S. Attorney Valukas to remark "I have a great deal of confidence in the staff of the Board of Trade." To further strengthen OIA, the Exchange has recommended further enhancements. These include:

- 9) OIA professional personnel will be expanded by thirty percent (30%) over 1988 levels;
- 10) The attorney staff exclusively supporting OIA efforts has been increased threefold.
- 11) Special training programs in investigative techniques conducted by professional consultants have been approved and instituted for OIA staff.
- 12) An increased presence of OIA investigators on the trading floor has been approved.

Board of Directors Policies

The Exchange has reexamined the powers, authorities and structure of its Board of Directors. The Exchange Board is currently a diversified body consisting of representatives from all aspects of the industry as well as public directors. The Rules of the Exchange and the diverse structure of the membership insure that such broad representation will continue to exist. To enhance the function of the Directors, the Board has approved the following measures:

- 13) The Board has approved and submitted for membership approval a rule amendment increasing the fining authority of the Board of Directors by more than three hundred percent (300%) from seventy-five thousand dollars (\$75,000) per violation to two hundred fifty thousand dollars (\$250,000) per violation.
- 14) The Board of Directors has formally reaffirmed its long-standing policy of excluding members with a history of significant trade practice sanctions from being on the Board of Directors and major exchange disciplinary committees.

Floor Practices

The Exchange has reviewed intensively existing policies, rules, regulations and practices governing floor trading. The Exchange believes that its rules and policies are highly refined to preserve both the utmost integrity and market efficiency. Nevertheless, the following enhancements have been made:

- 15) Although broker associations (as they are commonly understood) generally do not exist at the Board of Trade, the Exchange has adopted a rule requiring that any association of floor brokers must register with the Exchange in order to enhance the Exchange's surveillance of broker trading activities.
- 16) The Exchange has approved and submitted to the CFTC for its approval a rule establishing a modified closing call period at the conclusion of trading to better facilitate orderly execution of closing orders and increase the efficiency of price discovery during closing market periods. This rule includes separate identification of this modified closing call period for CTR-PLUS surveillance purposes.

- 17) The Exchange has prohibited floor clerks from maintaining trading accounts.

The Board of Trade also has done extensive work in two other areas which will enhance the audit trail and, therefore, Exchange surveillance capability. For many months, the Exchange has been developing an electronic order-entry system ("EOS") which will speed public orders directly to the pit via computerized entry; the resulting order record will be accurate to the second and will greatly enhance surveillance as well as better serve public customers.

Additionally, the Exchange has under review the development of a hand-held trade entry device for use by members on the floor to record electronically all their trades and instantly transmit the trades for clearing. Although the technology for such a device is not presently available, the Board of Trade and the Chicago Mercantile Exchange jointly have committed significant professional and financial (\$5,000,000) resources to the development of a hand-held trade terminal which will accurately record trade execution to the second.

The Board of Trade believes these improvements and others still under study will insure that its markets remain the world's most efficient, liquid and economical while simultaneously preserving the highest degree of integrity and professional participation. This is a goal which we believe that all of us -- futures exchanges, the CFTC, Congress and market participants -- share equally. Other exchanges (which have different markets, trade other products, have separate memberships and, in many cases, different market users) may have distinct needs with respect to enhancements of their existing systems. We strongly urge this Committee to consider these differences in its consideration of any legislation.

We believe that if the Committee does so, it will conclude that any regulation of the marketplace is best accomplished in a "management by objective" fashion. For example, when Congress and the CFTC mandated improvements to the audit trail in 1986, that mandate provided that each exchange should meet a common goal by whatever means is best suited to its markets. Thus, the Board of Trade and Chicago Mercantile Exchange responded by developing CTR. So too, in any new requirements for market enhancements and improvements, Congress and the CFTC should similarly establish broad objectives which the self-regulatory organizations are obligated to meet, but in the manner which they choose to best serve their particular marketplace.

The end result of such a management-by-objective approach will undoubtedly be the further improvement of our existing efficient, liquid and honest futures markets. The danger of failing to achieve this goal is that our current markets could easily be exported to foreign nations who are eagerly establishing new futures markets hoping to capture what is now a uniquely American industry.

THE EXCHANGE

The Board of Trade of the City of Chicago is the world's oldest and largest futures exchange. Founded in 1848, the Exchange currently is designated by the Commodity Futures Trading Commission ("CFTC") as a contract market for fifty eight (58) futures and futures options products, twenty six (26) of which are actively trading; these include grains, financial futures and precious metals. Four of the world's top ten contracts (by 1988 volume) are traded at the Board of Trade: United States Treasury Bond Futures; Options on U.S. Treasury Bond Futures; Soybean Futures; and Corn Futures. In 1988, the Exchange traded 143 million contracts, nearly twice that of the next largest domestic futures exchange and more than the next four domestic exchanges combined.

The Exchange strongly believes that the prevention of potential market abuses begins with the integrity of the membership itself. Innumerable member, staff and outside professional investigation hours are expended on each application to insure that the utmost member integrity is attained. In 1988, eight hundred twenty (820) applications for membership were processed by the Exchange. Members must trade (i.e. contract with) other members in the trading pits; the members therefore demand that admission to membership be a determination of individual integrity which ensures fair, honest and equitable dealing among members.

The Exchange membership consists of 1402 Full Members and an approximately equal number of Associate membership and membership interest holders. The membership is a diverse mix of individual ("local") traders, brokers, and member firms including futures commission merchants ("FCMs"), commercial firms, investment banks and other professional market participants.

All members are required by Rule to be "... of good character, reputation, financial responsibility and credit ..." as determined in the first instance by the Membership Committee and approved by the Board of Directors. Those wishing to be licensed floor brokers handling customer orders must also undergo additional investigation through the National Futures Association which includes an FBI fingerprint check.

Applicants are required to submit extensive background information which is subject to independent, professional verification. Applicants must also obtain the sponsorship of two existing members; on some occasions, sponsorship may entail a financial guarantee. The admission process includes at least one personal interview before the Membership Committee. Applicants are then recommended to the Board of Directors for approval or

disapproval. Those applicants recommended for disapproval are given the opportunity for a hearing. Disapproved applicants may appeal that action to the CFTC.

This rigorous membership approval process helps assure the fair dealing among members which forms the cornerstone of self-regulation. As commonly recognized, self-regulation does include the ability to promulgate and enforce one's own rules and regulations. Indeed, in 1988, the Exchange made seven hundred fifty-nine (759) rule and regulation revisions. Additionally, in 1988 cases, the Exchange issued charges for trade rule violations in sixty-nine (69) instances resulting in a total of seventeen (17) years of suspensions and \$1,480,000 in fines.

But self-regulation means more than rule promulgation and enforcement. It also means that members are not going to tolerate being treated unfairly or dishonestly by their fellow members. Most trading floor abuses involve a trading opportunity withheld from the entire trading arena. Fellow member-traders are not going to condone a lost trading opportunity. Indeed, the majority of Exchange disciplinary actions resulting in significant sanctions began with a complaint from a member regarding another member's conduct.

This is the essence of self-regulation: membership integrity upon admission coupled with the vested interest to preserve that integrity on the trading floor. It is by strict adherence to these principals that the potential for trading abuses is minimized even prior to surveillance, detection, enforcement and sanction. This is a principal reason market users have such confidence in Board of Trade markets. Indeed, in 1988, public market users made only thirty five (35) complaints to the Exchange regarding potential trade practice abuses. Considering the one hundred forty three million (143,000,000) contracts traded, this is a remarkably small percentage of complaints.

Nor is confidence in the integrity of Board of Trade markets, oversight and enforcement limited to professional market users. It is also shared by top law enforcement officials who have experienced through representation of clients at CBOT disciplinary hearings the thoroughness and efficiency of Board of Trade rule enforcement.

One of the things we do keep track of is what's taking place at the Board of Trade. We are interested in the proceedings at the Board of Trade. We're interested because, in my estimation based on my own expertise in the area, the best experts in the world concerning trading practices are the members of the Board of Trade. I have a great deal of confidence in the staff of the Board of Trade. They are able to ask the difficult questions; they have the resources to identify trading practices in which fraud has occurred.

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And frequently, in my experience, when they are holding their hearing, they are able to get to the tough questions quickly. And since the individuals that are subject to these proceedings are subject to examination, they ask those questions, get responses and those responses are on the record.

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We often in these cases call upon the Board to make an evaluation of members from the Board, individuals from the Board, in helping us to find whether or not there is a fraud involved. That is to say that we rely on their expertise. [Emphasis added.] Remarks of Anton R. Valukas, United States Attorney for the Northern District of Illinois, Kent Commodities Law Institute, Workshop on Enforcement/Criminal Matters, October 21, 1988.

It is this combination of innovative, efficient, liquid markets and a reputation among professional market users for unsurpassed integrity which is largely responsible for the Board of Trade's preeminent position in the world's futures markets. However, that preeminence is fragile. Competition for new markets among domestic exchanges, always fierce, has intensified. But more critically, the challenge of foreign competition for dominance in futures trading is increasing daily.

THE VALUE OF THE OPEN OUTCRY AUCTION TRADING SYSTEM

The open outcry auction trading system practiced on the floor of Chicago futures exchanges has been for over 140 years and still is the most competitive, open, efficient market trading system anywhere in the world. The U.S. Treasury Bond pit handles an intensity of transactions daily that is unmatched anywhere on any face-to-face, over-the-phone, screen or electronic system. In spite of the tremendous variety of alternative market systems, alternative risk management products and worldwide competition on and off exchanges, the Chicago open outcry auction futures markets are still the markets of choice for the most competitive international agricultural and financial firms in the world. They are also the only markets in the world where farmer and international grain trading firms or individual investors and international financial corporations can meet and trade on an equal footing to buy and sell with the same instantly available record of transaction prices continuously and openly available to all.

The New York Stock Exchange is the traditional economics textbook example of perfect competition in a market. Yet the specialist mechanism and the fact that the intensity of trading for even the most active stocks attracts only a trading crowd of five to ten traders makes even the New York Stock Exchange market far less an example of perfect competition than the open outcry auction futures pit. The active futures pit has hundred- of competitive traders each playing the stock specialist's role of trading and brokering trades simultaneously. Entry of new competitive traders to the futures pit is far more open than entry to a specialist post. The New York Stock Exchange is still considered the most liquid, competitive and open stock market in the world. By comparison, the intensity of and immediacy of trade demanded and supplied in active futures pits dwarfs the trading demands in the most active stocks. For example, on an average trading day in 1988, U.S. Treasury bond futures contracts worth \$28 billion changed hands while only \$180 million worth of IBM stock was traded.

The immediacy and intensity of trading demanded in the futures market and supplied by the open outcry auction style of trading is best illustrated by the price risk hedging demands of a primary government securities dealer. The primary government securities dealer (whether U.S. or Japanese) may and does buy more than one billion dollars worth at a time of long term U.S. Treasury bonds at a U.S. Treasury auction (which funds our national debt). The primary dealer buys that one billion dollars worth of bonds to earn a spread of one or two thirty-seconds of one percent of the value of those bonds over the several days or even weeks that it may take to sell all those bonds to long term investors.

However, in less than sixty seconds, the price of bonds can move five to ten times the amount of the dealer's expected spread. In a day's time a one or two percent change in price is not uncommon. That is 30 to 60 times the spread the dealer stands to earn. Hedging a large quantity of bonds in 10 seconds instead of one minute or in 5 seconds instead of 10 seconds can make all the difference in the world to a dealer and to his active participation in U.S. Treasury debt auctions.

Whether by computer, by specialist or by telephone no other trading system in the world has been able to provide a comparable price risk hedging vehicle for half a dozen or a dozen primary dealers who all need to hedge hundreds of millions of bonds at the same time right after a U.S. Treasury auction. The immediacy and intensity of hedging demanded by primary dealers has led to the perfecting of order flashing to and from the futures pit that permits trades to be executed in less than ten seconds. The ability of the open outcry auction system with hundreds of competing traders to provide multiple, simultaneous hedge trading executions in less than ten seconds is the essence of the value of this market.

The growth in trading volume and use of CBOT's Treasury bond futures corresponds with a growth in the federal debt from \$700 billion in 1977 when the futures contract was launched, to \$900 billion in 1980 when the contract traded 26,000 contracts/day, to \$1.9 trillion in 1985 with futures trading 160,000/day, to over \$2.7 trillion currently as the contract trades over 250,000/day. The primary dealers underwriting the Treasury's debt issuances, and the institutions and individuals that trade this debt and take it into their inventories, need a cost-effective way to manage the risks they face. The Treasury bond futures market provides the needed cost-effective risk management vehicle. Furthermore, its existence has fostered liquidity and, consequently, efficiencies in the underlying cash market. The \$31.25 bid/ask spread which now typifies Treasury bond futures trading is the standard in the cash market as well, in sharp contrast to the \$300 bid/ask spread which generally prevailed in the Treasury bond cash market before the introduction of the CBOT's contract. If this \$270 savings per \$100,000 face value Treasury bond is applied to primary dealers cash market transactions of \$15 billion/day, the efficiency gains in the Treasury bond cash market are well over \$10 billion/year due to the narrower bid/ask spread. This savings to primary dealers, and others active in the Treasury bond cash market, has resulted in more aggressive bidding at each Treasury auction and higher prices for each new debt issuance. Higher prices have meant lower costs of debt issuance to be borne by U.S. taxpayers.

There are a tremendous variety of competing alternative financial trading systems and price risk management products in the world constantly being developed and tested ranging from specialist style exchange traded systems to over-the-counter trading, clearing and screen listing systems to various electronic automated and semi-automated systems. A large number of these innovations have been used to compete with U.S. Treasury bond futures just because U.S. Treasury bond futures have been by far the most successful futures contract in the world. It is the contract against which the most competitive challenges have been launched by foreign exchanges.^{1/} Furthermore, it is the futures contract most copied as a model for foreign exchanges' listing of their own government bond futures contracts. Since 1982, long term government bond futures contracts have been launched by exchanges in the U.K., Japan, France, Australia, and five other countries.

The degree to which these foreign contracts are competitive with the U.S.-traded contract was illustrated vividly in October 1987. U.S. Treasury bond futures trading was brisk following the October 19, 1987 stock market break. On Tuesday, October 20,

^{1/} LIFFE, Sydney Futures Exchange and Singapore International Momentary Exchange (SIMEX) have all launched U.S. Treasury bond futures contracts. The Tokyo Stock Exchange will launch a U.S. Treasury bond futures contract on December 1, 1989.

prices of the CBOT's Treasury bond futures contract increased up to the upper limit allowed for a single day; as required by Exchange rules, trading in Treasury bond futures was effectively stopped. As a result, less than 35,000 Treasury bond contracts were traded during daytime trading at the CBOT on October 20 compared to the daily average volume of 286,505 during October, 1987. Instead, market users shifted their activity overseas to the LIFFE when their needs could not be met in the U.S. Volume in the LIFFE Treasury bond contract exploded to over 47,000 contracts traded on October 20, nearly eight times its average daily volume of 6,200 for the first ten months of 1987. The increase in volume at the LIFFE might have been even greater had market users been more familiar with that exchange and had they not had such a strong preference for the CBOT margin and clearing system. If U.S. futures markets cannot provide services needed by international users, they will seek these services at foreign exchanges.

In spite of competition from every quarter--domestic and international, on exchange and off-exchange, electronic and manual--the open outcry auction style trading of U.S. Treasury bond futures, with heavy reliance on flashing, has continued to grow in usage and attract the participation of premier institutions around the world. Open outcry auction market trading of futures is the trading style of choice in a highly competitive world market. Even the Japanese who have produced impressive results with semi-automated trading systems acknowledge the superiority of Chicago's open outcry auction trading system in providing liquid markets, as noted infra.

Finally, because of continuous trading, wide-spread price dissemination, and open access, the trade of farmers and international grain trading firms or individual investors and international financial firms can meet on equal terms in the futures pit. Because of the openness of membership access, these same groups can literally meet as equal members of the exchange in the futures pit. Stock exchanges around the world have been reluctant to even allow foreign firms as members, much less individuals. U.S. futures exchange memberships are open to entry by any firm or any individual in the world and because of the open outcry auction style of trading, direct participation in the pit of all those who wish to become members is possible. From an economist's viewpoint, this openness of entry (made possible in open outcry auction trading) is the essence of free competition.

Academic Commentary on Open Outcry

The benefits of organized futures markets are well documented in the academic literature^{1/} and in government agency reports.^{2/} While these benefits are readily seen by users and close observers, the market mechanisms which give rise to them are less clearly understood. Specifically, the value of the open outcry auction trading system used at the U.S. futures markets is not sufficiently understood or appreciated as a fundamental source of these benefits.

The following three excerpts from the academic literature lend support to the view that many of the benefits of futures markets would be lost under alternative trading systems.

Leo Melamed^{3/} describes the floor dynamics of the open outcry auction system, arguing that the existence of a trading crowd is essential to the efficient information processing needed for optimal price discovery:

"It is contended that elimination of the 'crowd' is insignificant, and will, in fact, improve the system. If this view were taken to its logical conclusion, then a host of 'crowd' functions that are still considered important could soon be eliminated. Certainly any form of town meeting or political convention could be made obsolete by automation. Delegates could easily signal their political preferences through some computerized mechanism. The votes would certainly be tallied faster. For that matter, Congress itself could be eliminated. After all, Congress is nothing but a 'crowd' of delegates representing its constituents. Congressmen could remain in their respective districts, where they are close to their constituencies, voting on issues by computer."

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- 1/ See, e.g., Futures Markets: Their Economic Role, Anne E. Peck (Editor), American Enterprise Institute, 1985; The Journal of Business, Vol. 59, No. 2, Part 2, April 1986; The Journal of Futures Markets, Vol. 4, No. 3, Fall 1984.
 - 2/ See, e.g., A Study of the Effects on the Economy of Trading in Futures and Options, Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Securities and Exchange Commission, December 1984; Financial Futures and Options in the U.S. Economy -- A Study by the Staff of the Federal Reserve System, December 1986.
 - 3/ Leo Melamed, "The Mechanics of a Commodity Futures Exchange: A Critique of Automation of the Transaction Process," Hofstra Law Review, Vol. 6, 1977.

"Several hundred people (at some exchanges over 1000) gather daily in a large room where they have easy access to each other. During the course of the business session, the room is inundated with statistics, news, and information. Price movements are highly visible and command attention. Each broker is expert about one or more of the markets traded at his exchange. Each participates in the markets by either acting as a customer representative, acting as an order filler, or trading for his own account. Each is on the floor to buy or sell, or both to buy and sell the futures contracts open for trading. Thus, it is incumbent on each to read, see, listen to, and discuss every conceivable factor which affects price movement of futures contracts.

The natural result of such a setting is easily understood. The exchange floor acts as a crucible of ideas, discussions, and arguments about futures and prices from which develop opinions resulting in bids, offers, and transactions. Moreover, the opinions generated on the floor further stimulate other opinions as they are transmitted through the communication networks and as they are intermingled with ideas originating off the floor."

Miller and Grossman^{1/} describe the importance of "immediacy"--instantaneous trade executions--futures market users and cite basic market mechanisms as the source for this immediacy:

"Successful futures markets are the leading examples of markets where the demand for immediacy is high. Futures markets are successful precisely for those commodities and in those time periods where price volatility, and hence the risks of delaying trading, is high. The price risks of volatility are further reinforced for potential hedger customers in those markets by the high leverage and extreme under-diversification of the underlying spot inventory positions that constitute their main line of business. Immediacy also becomes of particular concern where, as is frequently the case, the futures transaction is merely one leg of an inter-contract or inter-market hedge. Little or no risk may be incurred once all the components of the hedge have been put in place, but much risk is incurred when only some of the legs have been set. When the transactor is 'naked,' to use the colorful language of the trade, the delay of even a few seconds can become critical."

1/ Sanford J. Grossman and Merton H. Miller, "Liquidity and Market Structure," The Journal of Finance, Vol. 43, No. 3, July 1988.

"The demand for immediacy in successful futures markets is not only urgent, but sustained. The regular seasonal build up and build down of inventories, as commodities move through the production chain, creates a continual desire to trade, not just to hold futures. In financial futures markets, dealers' inventories of the underlying securities build up and down in response to periodic auctions of U.S. Treasury issues, to the flotation of stocks or bonds by corporations, or to the restructuring of portfolios by large institutional investors."

"The sustained demand for hedging and hence for trading futures quickly is often accommodated by designating a specific physical market place or exchange in which many competing market makers can offer their services simultaneously. Such arrangements help spread the fixed costs to market makers of maintaining a presence, as does the practice at most present-day futures exchanges of providing trading areas for many different contracts between which individual market makers can drift as trading interest changes."

Finally, staff of the Federal Reserve Board^{1/} also relate the provision of immediate transaction services to the open outcry auction system:

"Well-developed futures markets and cash markets both enjoy the services of middlemen, who allow buyers and sellers to effect trades without delay. There are several characteristics of futures markets, however, that allow middlemen there to operate more efficiently than in the cash market."

"Orders to buy and sell a particular issue usually do not arrive simultaneously in the marketplace. The lack of synchronization causes a delay to occur as orders are matched, and the market price may change in the intervening time. In a purely brokered market, the customer-trader would bear the cost of waiting for the broker to match an order with an opposite one from another customer."

"In well-developed markets, customers do not bear the burden of potential delays. Instead, a middleman (or marketmaker) takes the opposite side of each transaction, buying from sellers and selling to buyers (who could be other dealers). In the stock market, specialists often play this middleman role. In futures markets, local scalpers take the opposite side of orders from outside the pit. The pure

^{1/} Arnold Kling, "Futures Markets and Transactions Costs," Financial Futures and Options in the U.S. Economy -- A Study by the Staff of the Federal Reserve System, December 1986.

middleman's goal is to maintain no net position, instantaneously buying and selling securities at a small profit."

"The scalpers in the futures pits appear to perform their middleman function more smoothly than the dealers in the Treasury securities markets. The futures market is continuous: never is there a moment without a firm quote. Futures scalpers trade for a profit of one 'tick' (1/32 in bonds, 1 basis point in bills), whereas most dealers trade for two ticks."

In summary, the evidence presented by the researchers cited above lends support to the view that the open outcry auction trading system is a key component in the process by which high quality prices and transaction services are provided to futures market users. The dynamics of the open outcry auction are seen as being directly responsible for the high information content of futures prices. In addition, these prices are widely and immediately disseminated after they are discovered, via a worldwide vendor network. The researchers note that the auction provides the high degree of 'immediacy' needed by risk managers. And, the auction process is transparent and open to public scrutiny, unlike the 'upstairs' markets used in some trading environments.

The Experience with Automated Trading Systems

While there has been a movement toward experimentation with automated trading systems in the world's financial markets, their performance has been mixed, and clearly, attempts to date have been less successful in providing high quality markets than the traditional open outcry auction system. Of the top 20 futures exchanges in the world (according to volume performance in the first six months of 1989). Only one--the Tokyo Stock Exchange futures market--can be considered "automated," although human involvement is still required to effect actual trade execution. It accounts for only 4.3% of the world's futures market volume. Open outcry trading is the basis for the markets at the other exchanges, including those at the two largest foreign exchanges, the LIFFE in London and the MATIF in Paris.

In light of the difficulties experienced by automated markets, there is an unwillingness among those knowledgeable in the workings of U.S. futures markets to abandon the open outcry auction system for fear that the benefits of these markets would be lost. Several examples will illustrate these difficulties.

In the U.S., computerized futures markets have never succeeded. The International Futures Exchange, or INTEX, the first fully automated trading system, began trading in 1985. The exchange ceased trading in 1988. The INTEX trading system

connected brokers and traders worldwide into a trading system that matched bids and offers instantaneously, confirmed prices at which trades were executed on the computer screen or printer of the trader and maintained a public book of all bids and offers which were unfilled. The reasons for the failure of the system have been articulated most clearly by INTEX's President, T. McKiernan^{1/}. Mr. McKiernan:

"....is a firm believer in open outcry, calling it the most efficient way to run a market. His conviction comes, he says, from experience with Intex's problems in attracting liquidity to our electronic marketplace."

Thus, the most committed attempt to replace open outcry with automation failed in the words of its creator because the electronic marketplace cannot replicate the liquidity generated by open outcry.

As noted above, the only significant "automated" futures trading system is in place at the Tokyo Stock Exchange. The Computer-Assisted Order Routing and Execution System (CORES) used in trading the exchange's successful Japanese government bond futures contract is best described as a "semi-automatic" system. If a market buy and market sell order are entered into the system (or a marketable limit order - a limit order with a price at the current market price) the computer will automatically execute the trade with no intervention from a "Saitori" clerk. However, many orders arrive as limit orders which do not precisely match an opposite trade. These orders are registered on the electronic book display, from which point they either expire at the end of the trading day or will be matched on the basis of price and time priority by the Saitori clerk in accordance with the rules of the market: a lower offer takes priority over higher offers, and a higher bid takes priority over lower bids. While the CORES trading system has supported what has become the sixth most active futures contract in the world (Japanese government bond futures), market participants have pointed to difficulties with liquidity, stemming from the lack of a diverse trading population. The market is used entirely by large institutions which often seek large positions on the same side of the market (i.e.; either buy or sell) at a given time. As there are no locals to balance the transactional needs of the marketplace, trading may often be forced to stop until the liquidity can be reestablished. This is unheard of at the CBOT where the continuity of trading cited in the Federal Reserve study^{2/} is an essential feature of the

1/ Financial Times, October 23, 1987, p. 34.

2/ Arnold Kling, "Futures Markets and Transactions Costs," Financial Futures and Options in the U.S. Economy -- A Study by the Staff of the Federal Reserve System, December 1986.

market. Discussions with users of the Tokyo Stock Exchange futures market reveal that preference for the open outcry system of trading is wide-spread.

Most of the experience with automated trading has been in the equities markets. The Swiss Options and Financial Futures Exchange (SOFFEX), a totally automated exchange which began trading stock options in 1988, encountered serious problems with its systems in July this year. These problems raised numerous market integrity and security issues:^{1/}

"SOFFEX may be boasting about its first six months turnover, bringing it up to fifteen in the league table of options exchanges worldwide, with volume over 2.6m, but if its technological problems continue they may prevent the exchange from improving on that position. On one day last month, it seems gremlins again stopped trading--nothing new in itself, as this occurs once or twice a month--but this time the system, which went down before lunch, was not reinstated until the next day. Trading under these conditions carries on through a telephone market, but such stoppages are unlikely to fill observers with confidence about electronic trading. The Swiss exchange's technological problems do not end there. It seems SOFFEX will not launch its futures trading software before the middle of next year, says one source, after having suggested it would be ready in the first quarter of 1990. Will the futures industry see a repeat of the several delays experienced when the exchange opened last year?"

Problems at SOFFEX occurred again in August. The system was unable to accommodate trading volume which, though reaching a high of 50,000 contracts/day, is a small fraction of the 500,000-600,000 contracts/day traded at the CBOT:^{2/}

"The gremlins which stopped trading on SOFFEX temporarily in July, (FOW August), were well-behaved compared to those which brought about a three day break down in the system suffered last month. The failure occurred after the exchange attempted to install new software to meet SOFFEX's growing volume, which for the first time reached over 50,000 one day last month. As the failure persisted trading continued over the telephone, leading to criticism of the fairness and security of such a method of trading. The SOFFEX system had been experiencing some delays in response time, according to traders, due to the growing volumes. The exchange and traders must hope the new software will cope better than its predecessor."

^{1/} Futures and Options World, August 1989.

^{2/} Futures and Options World, September 1989.

Another foreign equities exchange experiencing difficulties in the introduction of increased automation in its trading systems is London's International Stock Exchange (ISE). In 1986, after London's "Big Bang", the Stock Exchange Automated Quotation (SEAQ) system was introduced, effectively moving all trading off the floor of the ISE and onto the SEAQ screen. The SEAQ system is not an automated trade execution system but an electronic information dissemination system which complements telephone trading. Part of London's efforts to modernize its financial markets and retrieve business lost to other financial centers, the system, as reported in the British press,^{1/} has encountered some problems which seem to relate to cost and potential market abuse:

"Big-ticket business is quitting the central, screen-based market and flowing to new, ad hoc markets, such as one formed between Britain's largest life insurers. The exchange's own automated share-dealing system for small bargains is threatened by rival and cheaper networks. The exchange's members are quarrelling: big traders accuse smaller, mainly American, firms of living off others' capital. And firms are losing a combined £500m (\$870m) a year from trading British shares, despite the much-touted synergies of all those hastily-assembled securities houses.

At the heart of the brouhaha lies SEAQ, the exchange's screen-and-telephone trading system. On its screens, traders post the price and quantity in which they are prepared to deal in a particular share. At first, institutions and brokers liked SEAQ for its transparency. But last summer the system started to cloud. Big share-traders complained that SEAQ's very transparency unfairly put their trading capital at the disposal of smaller market-makers rather than true customers. Rivals could dump shares upon each other, exploiting clues about who was short of a particular share or who was overloaded. So two big market-makers slashed the size of bargain in which they guaranteed to deal, from 50,000-100,000 to a piffling 5,000 for blue-chip shares. The prices displayed were no longer those at which big deals were being done."

In its rush to automate, the ISE may have done irreparable damage to the confidence and performance in the marketplace for equities in London. The equities market has become fragmented, it has lost its ability to accommodate large trades and it is no longer transparent to regulators and users.

The SEAQ System of the ISE is patterned after the NASDAQ (National Association of Securities Dealers Automated Quotations) system in the U.S. over-the-counter (OTC) market. The system, not a computerized system but rather a nationwide network of

^{1/} The Economist, February 11, 1989.

telephones, teletypes and computer terminals utilized to link market participants, has facilitated rapid growth of trading in the OTC stock market. Trade execution is not automated. Market participants negotiate with each other on the telephone, based on information available on the screen. Despite the system's success in fostering growth of the market, NASDAQ experienced a breakdown during the 1987 stock market crash. Immediacy, cited by Grossman and Miller^{1/} as essential in the case of futures markets, was out of the question and, for long periods, trade executions of any sort were impossible. The Brady report^{2/} concluded:

"From all of the evidence available to the Task Force it must conclude that, despite the fact that throughout the period of the market break trading continued at some level in almost every over-the-counter stock, the many participants who complained that the system broke down were accurate in their assessment. For customers seeking to buy or sell over-the-counter securities bid-offer spreads were wider than normal. The execution of smaller transactions was frequently delayed by the shutting down of SOES (Small Order Execution System) and the other automated execution systems until such time as the markets were no longer locked or crossed. When such executions did occur they were often at prices dramatically different from the price at the time the orders were originally placed. For others, including many institutional investors seeking to buy or sell larger blocks of stocks and many markets makers attempting to lay off positions, execution was often difficult to achieve. Many transactions apparently were executed at prices far different than those of other transactions executed at or about the same time.

Transactions often were not reported promptly, and in many instances it appears that transactions which were not reported promptly were not designated as having been reported late.

Many of the problems in the over-the-counter market during the market break were due to the closing down of SOES and the other automated systems in a large number of stocks. This placed such a great strain on the market participants who now had to revert to the use of manual systems that they could not interact with other market participants in the normal manner. Thus, those market makers who may have been willing to trade in depth were often so busy responding to the high volume of phone traffic and handling paperwork that many customers and other market makers were unable to trade with them."

^{1/} Sanford J. Grossman and Merton H. Miller, "Liquidity and Market Structure," The Journal of Finance, Vol. 43, No.3, July 1988.

^{2/} Report of the Presidential Task Force on Market Mechanisms, January 1988 (Study VI).

A survey of financial market users conducted by the Brady task force revealed that this OTC market was the poorest performing U.S. market during the 1987 stock market crash. When asked to rate the quality of market performance on October 19-20, 1987 against normal performance, 75.8% of the respondents felt the OTC market performed "Very Poor (less than 50% of normal quality)" in terms of dissemination of price and market information. Stock index futures, traded by open outcry, received this rating from 30.8% of those contacted. When asked about execution and clearing of trades, 64.7% of the respondents gave this low rating to the OTC markets; 33.7% in the case of stock index futures. The New York Stock Exchange and the Chicago Board Options Exchange markets also received higher marks than NASDAQ. Clearly, in the view of the market users involved in the survey, the "automated" OTC market experienced much more serious difficulties than the open outcry-based futures markets.

In contrast to the NASDAQ failure during the crash, the CBOT Major Market Index (MMI) futures market continued to function. As noted in the press,^{1/} at mid-day on Tuesday, October 20:

"....17 of the MMI's 20 stocks still were trading, albeit sporadically, on some regional stock exchanges. Just the day before, Mr. Mahlmann [CBOT Chairman] had received a phone call from Beryl Sprinkel; the chairman of the President's Council of Economic Advisers urged him to keep the Board of Trade open...

'We felt we had to stay open to do our job to provide liquidity', Mr. Mahlmann recalls. Then he and his executives made what turned out to be one of the most critical decisions of the day: They kept the Board of Trade open and continued to trade the MMI futures contract."

As these examples indicate, "automated trading systems" often may be unable to provide the kind of liquidity, immediacy and continuity which users of U.S. futures markets have come to expect. Moreover, they operate out of public view, not subject to the same careful scrutiny which can be given to the open outcry auction system, operating in the trading pits.

^{1/} Wall Street Journal, November 20, 1987.

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With regard to the pitfalls of automation, a recent GAO report^{1/} contained the following cautionary note:

"Automated systems....introduce risks that must be controlled to ensure that they do not reduce each exchange's ability to provide efficient, fair, and equitable treatment to all market participants. Although not meant to be all inclusive, the following list identifies some generic risks that need to be addressed:

---Correct processing: the need to ensure that the system hardware, software, and communications perform as intended. Risks include errors that cause orders to be processed incorrectly, or participants to receive privileged treatment.

---Responsive operations: the need to ensure that the system is properly sized and designed to support timely operations under normal and high-volume conditions. Risks include an inefficient system design and inadequate transmission, processing, and storage capacities.

---Secure operations: the need for established controls to prevent unauthorized access and the misuse of automated systems. Unauthorized access concerns include the failure to establish controls over who can enter the computer system processing area, who can use the system and who can access the information contained in the system. Misuse of automated systems includes disabling system controls, erasing audit trails, and accessing system information in an unauthorized fashion.

---Continuous service: the need to ensure service to users in the event of equipment and software failures, natural disasters, and intentional malicious acts. Risks include a lack of contingency plans to ensure that systems could conduct normal operations under conditions such as floods, fires, etc."

Taken together, the difficulties experienced by automated trading systems to date and the lack of certainty regarding their capabilities and potential pitfalls dictate extreme caution in future experiments with automation. Computerization is not the answer to all concerns with market performance. Moreover, the new problems it can create are not yet known or understood.

1/ Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks, General Accounting Office, September 1989.

Conclusions

This analysis has discussed the importance of the open outcry auction system of trading in the provision of transactions services by U.S. futures markets. It has documented the inability of automated systems to achieve the same efficiencies as open outcry.^{1/} An excerpt from a recent Institutional Investor article^{2/} summarizes both the strengths of open outcry and the pitfalls of automated trading:

"Watch the government bond futures pit at the Chicago Board of Trade, and you're looking at some sort of thousand-armed monster, where contracts move from local to local as fast as impulses from neuron to neuron.

Making traders push buttons and wait for machines would significantly alter the pace of trading. In particular, speed is critical for any trader making markets and exposing quotes for other traders to hit. This was a major gripe initially among SOFFEX traders in Zurich. "Trading is a little slow. If I push the button to hold my quotes, it can take ten seconds," says Alessandro Pelli, a trader at Union Bank of Switzerland. That may sound fast, but in a fast-moving marketing it can be too long.

Perhaps the biggest risk of an automated exchange, however, is one that is common to all new technology: People will come to rely on it, and then it will break down. On most systems, traders complain that the system slows down when things get busy, which of course is precisely when they want

1/ The CBOT continues to move toward the incorporation of state-of-the-art technology into its markets. The exchange is developing a screen trading system, "Aurora," which will be utilized in making CBOT markets available at times of the day when the open outcry auction system is impracticable. It is being developed as the only available alternative by which the CBOT can make its markets available 24 hours a day, in response to international demand and the growing threat of competition from overseas exchanges. The Exchange does not believe that Aurora, while superior to automated order matching systems, is nearly as efficient as open outcry. Hence, open outcry will continue to be used whenever practicable. The exchange is proceeding carefully in developing and testing Aurora to ensure it will not experience the difficulties of other automated systems.

2/ "The Wild, Wired World of Electronic Exchanges," Institutional Investor, September 1989.

to be trading most nimbly. In Japan, CORES has actually crashed at hectic times. Says Mitsuo Sato, senior managing director of the Tokyo exchange: 'Human activity is very flexible. Computers are not flexible.'

The open outcry auction system itself is one of the U.S. futures industry's principal weapons against foreign competition. Ten new futures exchanges have been established overseas in the last five years. The number of products traded on foreign exchanges has nearly doubled in that time period. Table 4 (attached) shows how quickly newly introduced futures contracts at foreign exchanges have grown to challenge U.S.-traded contracts. Each time a new futures product is introduced overseas, the goal is the same--to provide the same high quality price and transaction services as the U.S. futures markets, the world's standard. As argued in this analysis, this high quality is directly related to the open outcry auction trading system. Altering this system would severely damage U.S. competitiveness.

Finally, the U.S. futures industry is moving in the direction of automated enhancements to trading, as noted above. The process has begun and it will proceed, encouraged by the pressures of international competition and a demand from users for the best possible transactions services. This evolution is best allowed to continue at a pace dictated by business experience, customer demand and technological integrity; not by fiat. The experience of the International Stock Exchange has shown -- in eroded pricing efficiency, a fragmentation of its market, and a loss of market participation -- mistakes can be costly.

FOREIGN COMPETITION

The efficiency and liquidity of United States futures markets are the envy of the entire world. Virtually every major nation on earth -- Japan, Great Britain, France, Switzerland, Australia and even China -- has established futures markets in the image of Chicago's futures markets. These foreign futures markets in many instances are directly subsidized by the national government and are strongly supported by national mandate. There is no secret to futures contract specifications; they can be imitated by photocopy in minutes. It is the experience, expertise and integrity of the floor trading population which establishes Chicago's futures markets as the world leader. But, that market edge is fragile and could be easily upset or destroyed.

The foreign challenge to the U.S. futures industry has increased markedly in recent years. Although activity at U.S. futures exchanges has continued to grow, activity at foreign exchanges has grown much faster. The market share of U.S. exchanges has declined because futures exchanges have proliferated

overseas; products offered by foreign exchanges have become more diverse as the benefits of futures markets become better understood. Foreign exchanges now compete directly with American exchanges; there are now several contracts traded on foreign exchanges which are identical to contracts traded domestically.

The statistics are sobering, if not frightening.

In the past four years, the Board of Trade has increased its total volume of contracts traded by 91%. However, during that same period, the Exchange's market share of world-wide futures volume decreased by 3.6 percent (from 37.6% of the world market to 34%). The reason the Exchange lost world market share was that foreign exchange volume grew 226%. (See Appendix 1, Table 1 and Figure 1).

In 1985, the ten most actively traded futures contracts in the world were all United States products. By 1986, the fifth most actively traded contract was Japanese, a position which it continues to hold today. By 1987, the seventh most actively traded contract was French; today, the French Bond Futures contract has grown to occupy the number six position on the list. (See Appendix 1, Table 3.) In 1985, no foreign futures contracts were among the twenty-five most actively traded. Today, six of the top twenty-five are foreign contracts. (See Appendix 1, Table 4).

From 1984 to 1988, the number of domestic futures contracts trading grew 34%. But the number of foreign futures contracts trading grew by 84% in that same period. (See Appendix 1, Table 2). The London International Financial Futures Exchange ("LIFFE") trades a U.S. Treasury Bond Futures contract identical to the Board of Trade's most actively-traded contract. Volume in the LIFFE U.S. T-bond contract has tripled since 1985 to over two million contracts per year.

Statistics prove that market users are willing and able to quickly shift their market activity overseas. For example, U.S. Treasury Bond futures trading was brisk following the October 19, 1987 stock market break. On Tuesday, October 20, prices of the Board of Trade's Bond futures contract increased up to the upper limit allowed for a single day; as required by Exchange rules, trading in T-bond futures was effectively stopped. As a result, less than 35,000 T-bond contracts were traded during daytime trading at the CBOT on October 20 compared to the daily average volume of 286,505 during October, 1987. Instead, market users shifted their activity overseas to the LIFFE when their needs could not be met in the U.S. Volume in the LIFFE T-bond contract exploded to over 47,000 contracts traded on October 20, nearly eight times its average daily volume of 6,200 for the first ten months of 1987. (See Appendix 1, Table 6). The increase in volume at the LIFFE might have been even greater had market users been more familiar with that exchange and had they not had such a strong preference for the CBOT margin and clearing system.

Despite the well-known integrity and liquidity of the CBOT T-bond contract, participants in the T-bond market sought risk management services elsewhere once trading in the CBOT market stopped. This event demonstrates the ease of shifting futures market activity abroad if necessary. Thus, even the world's most active futures contract is vulnerable to foreign competition.

It is clear that there are now numerous risk management vehicles available to those who need to hedge against price risk and to speculators who are willing to accept that risk. American futures markets compete not only with foreign futures exchanges, but also with alternative risk management vehicles such as forward contracts, swaps, caps, collars and other off-exchange, unregulated products. These various risk management products are available at the touch of a telephone button; global markets are all easily accessed and are becoming more familiar to market users.

The availability of so many other methods and locations to conduct risk management means that any increase in the costs of using one of these vehicles can result in a huge disadvantage relative to the competition. This high degree of competition means that market users benefit as each provider must keep its costs low, and the quality of customer service must be maintained in order to keep customers. On the other hand, any regulations that increase the cost of using futures markets or reduce the quality of customer service being provided will put the U.S. futures industry at a competitive disadvantage. To choose but one instance, restrictions on broker trading would reduce the efficiency of U.S. futures markets and would lower the quality of service provided to users of these markets. (It should be noted that broker trading commonly is permitted in foreign markets.)

In the face of such intense, dedicated international competition for what were only a few years ago, uniquely American markets, Congress must carefully consider its actions to avoid any action which could cripple domestic futures markets. Even foreign journalists whose home markets stand to benefit from any hasty U.S. legislative reaction have expressly cautioned us not to enact ill-considered legislation.

"America's politicians would therefore be well advised to temper their natural desire to "do something" and refrain from hasty ill-considered regulation of Chicago. That "casino", as it is described by its opponents, is in fact one of America's most successful industries.... Tokyo and London, not to mention other financial centres, would clearly love to get a bigger slice and will seize any opportunity to do so. It was, it needs to be remembered, ill-considered American legislation in the 1960's that allowed London to become

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the centre of the international debt markets, usually known as the Euromarkets." Future Permanent, The Economist, June 11, 1988.

Today, we have the best futures markets in the world, reputed for both their cost efficiency and market integrity. We must carefully preserve that delicate balance in the face of our less regulated foreign competition as we consider any proposals for regulatory change. We must not deceive ourselves into thinking that our foreign competitors will not create a quality product at the lowest price possible. The proof is self-evident; they have done so in countless other industries where the United States was only recently the world leader.

OVERSIGHT & ENFORCEMENT

Competition for market share is not dependent solely on market liquidity and efficiency. Market users value the integrity of the trading process very highly. While strict member admission standards and vested self-interest form the foundation of market integrity, vigorous oversight, surveillance and enforcement are also of paramount importance. As a membership self-regulatory organization, the Board of Trade insures compliance with fair and equitable trade practices principally through the Floor Governors Committee, the Business Conduct Committee, and the Board of Directors.

The duties and powers of the Floor Governors Committee are generally defined by CBOT Rule 543.00 which provides that the Committee shall assure that the practices and conduct of members of the Association, member firms and other persons with trading privileges on the Exchange Floor are in compliance with the Rules and Regulations of the Association. The Committee is authorized to take action against persons and firms including: (1) dismissal of charges and closing the matter; (2) issuance of a warning letter; or (3) issuance of preliminary charges and scheduling of a hearing on the merits. If preliminary charges are issued, the Committee will afford the respondent(s) an opportunity for a formal, evidentiary hearing of record with right to counsel. If, after hearing, the Committee determines rule violations have occurred, the Committee may: (1) fine up to ten thousand dollars (\$10,000) per violation; and/or (2) suspend the respondent for up to ninety (90) days per incident; or (3) may charge the respondent and refer the matter to the Board for the imposition of sanctions.

Additionally, Regulation 540.09 provides respondents with the opportunity and means to settle preliminary charges. Settlements may be accepted on such terms and conditions as the Committee may deem appropriate.

The duties and powers of the Business Conduct Committee are generally defined in CBOT Rule 542.00 which provides that the Committee is responsible for preventing price manipulation and the cornering of any commodity on the Exchange, insuring the orderly liquidation of expiring contract months and for supervising the business conduct of all members, member firms and other persons with trading privileges. In regard to the latter responsibility, two of the duties of the Committee are: (1) to enforce the minimum capital rules of the Exchange, as approved by the CFTC; and (2) to enforce Exchange Rules and Regulations pertaining to the handling of customer orders, customer accounts and margins. Other duties include reviewing requests from firms to pre-pay subordinated loans, supervision of firms that are regular for delivery on Board of Trade agricultural contracts, and all general matters of member solvency.

The Committee is authorized to impose specific disciplinary sanctions; to recommend that the Chairman impose restrictions on the operations of a member, member firm or other person with trading privileges; and to impose restrictions on member FCMs that fail to meet the capital requirements of the Exchange. The Committee also is authorized to order any member to cease and desist from past or proposed conduct that it finds, after notice and an opportunity for hearing, to be unfair, unjust or in violation of CBOT Rules and Regulations. The Committee may impose a fine of up to twenty-five thousand dollars (\$25,000) for each violation and/or suspend a member for up to ninety (90) days. Cease and Desist Orders are final and not appealable. As an alternative to issuing a Cease and Desist Order and/or a fine in disciplinary matters, the Committee may file charges against a member, member firm or other person with trading privileges with the Board of Directors.

Decisions of both the Floor Governors Committee and Business Conduct Committee generally are appealable to the Board of Directors. The Committees may also refer charges to the Board for its disposition where the Committee feels its sanctioning authority is too limited for the severity of the violations found. Thus, the Board functions in the one instance as a pure "appellate" body, and in the other purely as a sentencing forum. In either instance, a general right of appeal from a Board decision to the CFTC is provided by Part Eight of CFTC Regulations.

Member disciplinary committees are uniquely qualified to enforce Exchange rules. The knowledge of trade practices and experience with the business of futures trading possessed by these members cannot be duplicated outside the Exchange. Members of the Floor Governors Committee and Business Conduct Committee typically have ten to twenty years experience in futures trading, most of it at the Exchange. This member expertise is an invaluable and irreplaceable asset in the oversight and enforcement of Exchange rules.

Equally valuable as member expertise is the professional staff support the Committees receive. The Board of Trade continually monitors member and member firm compliance with its rules and regulations, as well as those of the industry, through its Office of Investigations and Audits. As part of its surveillance efforts, the OIA is constantly in contact with other Exchanges, the National Futures Association and the CFTC to exchange relevant information.

OIA is comprised of five interrelated departments. The Investigations Department is responsible for investigating inquiries from customers and referrals from members, member firms and the CFTC concerning any market activity or trade practices which involve potential violations of Board of Trade rules and regulations. These investigations involve a comprehensive process of obtaining statements from witnesses and parties involved, conducting trade reconstruction reviews and analyzing trading documents. The department may close cases administratively when there is insufficient evidence of rule violations. All cases involving potential rule violations are submitted to the appropriate Exchange disciplinary committees. The department is responsible for the preparation and prosecution of cases involving its investigations.

Staff of the Investigations Department is also responsible for initiating and conducting Trade Practice Investigations ("TPIs") on a continuous basis. TPIs involve reviewing daily exception reports of the Exchange's trading activities of members and member firms to detect patterns of conduct which may indicate rule violations. TPIs are conducted utilizing the Computerized Trade Reconstruction System.

The Investigations Department also maintains a floor surveillance program that involves directly observing floor trading activity on a daily basis.

The Reporting and Research Department is responsible for auditing the Board of Trade's CTR system. It also conducts surprise on-site reviews of all audit trail data submitted by members and member firms. The department is also responsible for maintaining OIA's other various computer systems and coordinating the department's interaction with the CFTC.

The Market Surveillance Department ensures the orderly expiration of all Board of Trade contracts and monitors trading activity in order to detect attempts at price manipulation, squeezes of a commodity or corners in a market. To accomplish these tasks, Market Surveillance compiles and reviews information relating to volume, open interest, current cash commodity prices, available stocks, deliverable supply, and positions held by clearing member firms and large traders. Market Surveillance's analysis of this information identifies futures/cash price

relationships which may potentially be disruptive to the marketplace. Statistical reports including historical market data are also compiled weekly.

During a month in which a futures contract is eligible for delivery or expires, Market Surveillance may be in frequent contact with major participants. With respect to stock index futures contracts, Market Surveillance communicates with members of an intermarket surveillance group that includes staff from the New York Stock Exchange, the American Stock Exchange, the Chicago Mercantile Exchange, the Chicago Board Options Exchange, the Philadelphia Stock Exchange and the Kansas City Board of Trade.

The OIA's Financial Surveillance Department ensures that all Board of Trade member firms comply with the Exchange's capital rules and capital guidelines. The Financial Surveillance Department routinely analyzes the financial health of member firms with the Simulated Analysis and Financial Exposure ("SAFE") system, the most sophisticated computerized financial surveillance program in the futures or securities industries. The SAFE system evaluates the risk of member firms at current market levels and at a variety of combinations of different market and volatility levels. The SAFE system generates approximately one hundred different reports, including but not limited to pay/collect information,^{1/} margin data, and large trader reports. The OIA shares use of the SAFE system with the Board of Trade Clearing Corporation, which developed the system. Recently, the securities and commodities exchanges have formed the Intermarket Financial Surveillance Group ("IFSG") to share and coordinate in matters relating to financial concerns. CFTC and SEC representatives also serve as advisors to this group. The IFSG continues to evaluate the risk of futures option and securities business to coordinate in the oversight of market participants.

Any actual or potential problems discovered during the analysis results in an immediate phone call to the firm or an on-site financial review. Member firms are also required by the Board of Trade regulations to notify the Financial Surveillance Department of changes in key financial data.

The OIA Audits Department conducts biennial reviews of the books and records of each Board of Trade member firm that is registered as a Futures Commission Merchant ("FCMs") to determine compliance with Exchange rules and regulations. Audits focus on the firms' financial and compliance procedures. During a financial audit, a firm's financial condition is analyzed, along with the composition of balance sheets and capital computations to verify that the firm has appropriate procedures to ensure the continuous submission of accurate financial information to the Exchange. Also, customer balances are reviewed and the proper segregation of customer funds is verified.

^{1/} The SAFE system currently reports this information for all U.S. futures exchanges.

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The compliance portion of the audit examines a member firm's procedures for customer order preparation and processing margins, opening an account; account documentation and discretionary accounts. Cash transactions are reviewed to establish that the firm is properly accounting for customer transactions. The Audits Department also makes surprise sales practice reviews of member FCMs' branch offices and guaranteed introducing brokers. These reviews cover the solicitation of customer accounts and customer complaints.

One of the principal tools used by OIA to conduct its market surveillance and investigation responsibilities is the Computerized Trade Reconstruction System and its derivative system, CTR-Plus. CTR is the world's most sophisticated market audit trail. CTR documents who traded what quantity of which contracts at what price and the determined time of execution is stated to the nearest second for all (100%) of the contracts traded on the Exchange. Critically, CTR data is available within twenty-four hours.

Created by the Exchange in 1986 in conjunction with the Chicago Mercantile Exchange, CTR eliminates the possibility of individual human manipulation of times, without impairing market liquidity as would occur by requiring traders to mark execution times. CTR is the software marriage of two independent computerized trade records, the clearing trade settlement record and the price reporting time and sales journal. By eliminating reliance upon human recording of times, CTR enhances reliability of the audit trail data.

CTR-Plus is comprised of the computerized programs designed by OIA staff, member committees and outside professional consultants to monitor trade activity via computer. Although it previously relied upon statistically valid trade samples, CTR-Plus now reviews 100% of the Exchange's trading activity with a variety of sophisticated surveillance programs. These programs monitor for potential abuses such as trading ahead of customer orders ("broker frontrunning"), crossing orders, taking the opposite side of a customer order, prearranged trading, ring trading, wash sales and other similar potential violations of Exchange and CFTC trade regulations.

Simply stated, CTR is the world's best audit trail and CTR-Plus the world's most sophisticated trade surveillance program. Nevertheless, the Board of Trade recognizes that success is a journey, not a destination. Improvements are always possible. Therefore, an Exchange select oversight committee has been intensively reviewing CTR and CTR-Plus to improve their accuracy and effectiveness. Those enhancements adopted to date are specified hereafter.

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In 1989, an industry group was formed called the Joint Compliance Committee ("JCC"). JCC is comprised of all U.S. futures exchanges and is attended by representatives of the CFTC. The group has begun the ongoing process of evaluating various methods used by exchanges to detect trade practice abuses and their effectiveness, and to insure the highest level of confidence and integrity within the industry as a whole.

Additionally, the Board of Trade and the Chicago Mercantile Exchange have agreed to combine their respective systems and expertise to create one, unified audit trail and surveillance system which can be used industry-wide. The resulting enhancements and improvements to the audit trail and related analytical systems, already the world's best, will serve as a model to other markets and a formidable deterrent to any potential trade practice abusers.

THE FEDERAL INVESTIGATION

This Committee is well aware that in July indictments were issued against twenty-one (21) traders and one clerk at the Chicago Board of Trade and twenty-four (24) individuals at the Chicago Mercantile Exchange. Of those individuals alleged to have been involved in trading irregularities at the Board of Trade, at this time, seven have entered pleas of guilty. These guilty pleas encompass fifteen (15) counts of wrongdoing, of which at least four counts are misdemeanors.

Initially, the Board of Trade does not condone -- and never has condoned -- fraud or any other trade practice abuse. The Exchange has consistently charged and sanctioned rule violators with penalties ranging from fines to suspensions and expulsions. We have developed CTR and CTR-PLUS as part of our commitment to the goal of ensuring fair and honest markets on which the public and member alike can rely. Should any federal investigation result in proven causes of fraud, we endorse and support the elimination of dishonest traders from the markets.

The Board of Trade has repeatedly stated its position that even one instance of wrongdoing on its trading floors is one too many. But we must also remember that all allegations made against the traders who have entered not guilty pleas are just that, "allegations." They are entitled by law to presumption of innocence until proven guilty.

Moreover, we cannot lose sight of what is known and established presently. What is known is that the United States Attorney has assured the Board of Trade that the Exchange itself is not the target of any investigation. What is also of record is the thoroughness and stringency of Exchange member admission

policies and practices. What is established is the excellence of the Board of Trade's CTR-Plus system, a system which identified prior to subpoenas being issued the suspicious trading practices of an FBI "mole" trading as a member. Most importantly, what is evidenced by the market enhancements detailed below is the uncompromising dedication of the Board of Trade to improving its already excellent oversight and enforcement programs.

APPROVED MARKET ENHANCEMENTS

There can be no doubt that the history of the Board of Trade to this day is a unique and enviable story of success. From pioneering fair, liquid, efficient agricultural futures in the previous century to the introduction of financial futures, the creation of trading options on equity securities and the growth of the world's largest futures contracts, the Board of Trade has an unsurpassed record of achievement.

Nevertheless, the Board of Trade recognizes that innovation and improvement are on-going, evolving efforts, not merely an excuse to point with pride to past achievements. The Exchange is constantly examining its market mechanisms and surveillance techniques to insure the continued success and user confidence in our markets.

In recent months, the spotlight cast by the federal investigation and subsequent indictments intensified the Board of Trade's existing evolutionary development of market mechanism refinements and surveillance system improvements. While self-regulation and self-interest alone would require such examination, the potential for lost public confidence in the integrity of these markets demanded a redoubled effort. Consequently, numerous Exchange committees were delegated the task of a thorough review and examination of numerous issues including trade practices, trade rules, CTR and CTR-Plus refinements and membership qualifications.

That review process has culminated in nineteen (19) major recommendations which have been approved by the Board of Directors for implementation. The Exchange's Board of Directors and membership believe this program of enhancements to existing rules and systems will make significant substantive improvements to the already efficient functioning of our markets as well as help to assure that degree of public confidence necessary for the markets to function effectively. A brief description of each action follows.

Broker (Dual) Trading

Despite the lack of allegations of dual trading abuses in the federal investigation, those who have long misunderstood the role and value of broker trading have chosen to use this legislation as an "opportunity" to resurrect their objections and misconceptions. Thus, it appears that Congress must (once again) carefully study and evaluate the function that broker trading performs in the markets.

The practice of broker trading, or trading as a principal and as an agent, is widespread in the United States and abroad. For example, broker dealers as well as futures commission merchants ("FCM's") trade for the firm's proprietary account and also handle customer orders. Securities specialists are not only permitted, but in some instances, obligated, to trade for their own account while simultaneously executing customer orders. Thus, any examination of floor broker trading in futures contracts also should require review of the identical phenomena in the structure of FCM's, broker dealers, securities specialists and others.

Broker trading provides a significant benefit to the futures markets. It adds substantial liquidity to the market. For example, over a three week period in fourth quarter 1988 in the Exchange's Treasury Bond futures contract, broker traders executed an average of almost 58,000 contracts per day for their own account. The Exchange's updated analysis^{1/} (attached hereto as part of Appendix 2) shows that futures market liquidity provided by broker trading may amount to as much as 80.0% on a daily basis across all contracts analyzed and as much as 54.0% in the Exchange's most active contracts. Because broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets and more capital; this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity is provided by broker traders (for the benefit of all market users), presents further statistics describing the extent of broker trading activity, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

Broker trading is particularly valuable to the Board of Trade because of the nature of our markets. Extensive spreading activity has characterized the contracts at the Exchange, which together with broker trading has been a key part of these

^{1/} The study notes the Exchange's objections to the definitions which the CFTC required the Exchanges to use for purposes of the data analysis. Therefore, more analysis is necessary to verify the accuracy of the data as requested by the CFTC.

particular markets and has helped them become the most efficient in the world. The price relationships among the delivery months in the grain contracts, for example, are the basis for hedging long term storage costs, an application of spreading which is an integral part of the U.S. agricultural industry. Likewise, the cost of carrying government securities can be hedged through spreading in contracts such as Treasury Bond futures at the Exchange. The role of broker traders is particularly critical in facilitating inter- and intra-market spreading, thus distributing liquidity across commodities and delivery months and forcing bid/ask spreads (customer costs) as low as possible.

In addressing concerns that potential trading abuses may be associated with broker trading, we must carefully differentiate between the valuable practice of broker trading and the potential trading abuses which may use that practice as a vehicle. By analogy, the practice of check writing is occasionally abused by some who draft fraudulent checks. Restricting or prohibiting check writing would not address the abuses, but it would destroy a valuable, legitimate economic activity. Ensuring that a sound means of detecting abuses is in place and that a stringent set of sanctions has been defined and is applied as appropriate is a more direct and logical approach to dealing with trading abuses than the restrictions or prohibitions of broker trading which some have proposed. Importantly, this approach would not damage market performance as a broker trading curb would.

It is critical to keep in mind that the Exchange's CTR-Plus system enables OIA to easily pinpoint any instances of abuse. Additionally, enhancements which have been made recently and which are planned in this system will further insure even greater deterrence of potential abuses, especially given the severe penalties which are applied if such trading abuses are detected. This self-regulatory system which combines ease of detection with strict penalties provides an effective deterrent of potential abuses which may be associated with broker trading at the Exchanges.

The experience of the domestic grain markets (principally corn, wheat, soybeans and oats) from 1983 to date is a vivid illustration of one aspect of broker trading's value. Beginning in 1984, these markets experienced a "depression" characterized by abundant domestic supply and stable prices. For the futures markets, this situation meant vastly decreased need to hedge risk (since cash market price risk was reduced) and, consequently, decreased futures market volume. For four years, floor brokers and independent traders experienced a "drought" of business and concomitant decreased opportunity to earn a living. Many were forced to leave the pit; some were forced to sell their memberships. Then, suddenly in 1988, the drought market greatly increased price uncertainty; thus, the need to hedge price risk exploded virtually overnight. With that need came increased futures orders and volume.

Critically, had brokers not been able to trade for their own accounts during the 1984, 1985, 1986 and 1987 markets, many more would have been forced to leave the pit and seek their living elsewhere. Had that happened, the 1988 market users would have found few, if any, experienced brokers to execute their orders and vastly reduced market liquidity.

Futures markets are not indestructible; they are highly fragile. Banning broker trading could well set America up to lose its ability to price its own commodities; the experience of 1984-1988 markets vividly shows how that could occur.

However confident the Board of Trade is regarding the value of broker trading and the ability to detect and punish potential abuses, we recognize that the public debate generated concerning the subject requires careful, professional analysis. For that reason, the Exchange has retained Dr. Sanford Grossman, the John L. Weinberg Professor of Economics at Princeton University, to complete a detailed, empirical study of broker trading. Dr. Grossman is a world-renowned market expert who, among other recent duties, was a primary contributor to the report of former U.S. Attorney General Nicholas de B. Katzenbach to the New York Stock Exchange following the October 1987 stock market crash. Dr. Grossman's preliminary findings are referenced herein.

With expert analysis such as that provided by Dr. Grossman, Congress will be able to assess better the true value of broker trading to our vibrant but fragile futures markets. Armed with such background, we should all be in a position to determine what modification, if any, is necessary. In so doing, we must also carefully evaluate the differences in different markets.

Additionally, trade patterns and practices vary widely from exchange to exchange and even within different markets on each exchange. Therefore, only through "management-by-objective" -- the setting of ultimate goals to be achieved by a variety of means -- can regulation in this critical area function without risking irreversible damage to the markets. Since we all share the common objective of honest, liquid, efficient futures markets, the Exchange is confident that a management-by-objective regulatory approach for broker trading will work as well as this approach worked in 1986 when the CFTC adopted it for the audit trail question.

Exchange Surveillance Enhancements

The Board of Trade's market surveillance system, CTR-PLUS, is built upon the world's finest audit trail, CTR. Regardless of their excellence, CTR and CTR-PLUS are new systems, fully operational only since July, 1987. Therefore, independent of recent events, the Exchange has been evaluating improvements and

enhancements to the system. These recent intensified committee reviews have already resulted in Board approval of the following significant enhancements to the systems:

(1) CTR-PLUS now reviews every trade transacted on the Exchange.

Originally, CTR-PLUS was created (as are all standard audit systems) to review a selected, statistically valid sample of data rather than the entire data base. Recent technical advances and our long-standing commitment to improvement have now resulted in the expansion of CTR-PLUS review to every trade transacted in the Exchange's markets. This would be equivalent to the Internal Revenue Service auditing every taxpayer's return rather than the statistically valid sample which it does. The result should be not only greater effectiveness of trade practice surveillance, but also greater deterrence to any potential abusers.

(2) The Board has authorized one million dollars for CTR and CTR-PLUS improvements.

Sophisticated, effective surveillance systems require the investment of both expertise and capital. The development of CTR and CTR-PLUS was never hindered by budget restrictions. Nevertheless, to further enhance the systems will require additional funds. The million dollar fund approved by the Board evidences the Exchange's commitment to continued system enhancements.

(3) Trade bracket recordation times will be reduced fifty percent (50%).

The effectiveness of CTR-PLUS is in part dependent upon the time-bracket periods used by floor traders to time trades. Currently, thirty (30) minute bracket periods are required. The Board has approved reducing those periods to fifteen (15) minutes, a significant improvement. As a result, the already high accuracy rate of CTR times should improve even further.

(4) Market openings and closings will receive separate, five (5) minute trade time recordation brackets.

A substantial portion of the volume in any market occurs during the opening and closing periods. To further improve the audit trail and surveillance of these critical periods, the Board has approved separate five (5) minute brackets for these critical periods of trading.

(5) Trade card recording requirements have been strengthened and improved.

The CTR and CTR-PLUS systems rely in part upon the accuracy of trade data reflected on a floor trader's individual trading

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cards. The accuracy of those systems will be further enhanced by Board approval of new requirements: (1) all trading card records must be accounted for; (2) all trading cards must be collected by clearing firms on an hourly basis and time-stamped, thus insuring the trading cards are out of the traders' hands; and (3) all trades must be submitted to the Clearing House within one hour of collection. These steps will not only enhance the audit trail and surveillance systems, but the clearing process as well.

(6) CTR-PLUS has been technologically enhanced.

Being a computerized system, CTR-PLUS is able to be improved by technological innovations and enhancements. The Board has approved several such enhancements to CTR-PLUS including: (1) an expanded relational data base to permit more rapid investigations of trading activities extending back in time (i.e. expanding from a "snapshot" of trading activity to permit an investigator to scroll over an extended period of trading activity); (2) expansion of the number and nature of surveillance tests conducted on a routine basis; (3) use of expert systems technology which will permit investigators to quickly design programs to specific needs; and (4) expanded storage capacity which will permit rapid access to one year's data. These technological enhancements should speed investigations and increase the efficiency of professional investigator resources.

(7) All exchange floor clocks will be synchronized to an Exchange master clock.

A critical element of CTR and CTR-PLUS is accurate times. Currently, there is no requirement that the hundreds of Exchange trading floor clocks which are used to time stamp customer orders be synchronized to within ten-second intervals across the floor; therefore, minor discrepancies in times can occur which may affect CTR logic. The Board has approved synchronizing, at considerable cost, all trading floor clocks to one master clock to insure uniform, accurate time information being input into CTR.

(8) Five (5) computer programmers have been added to enhance all OIA surveillance programs.

As noted previously, the Exchange regards the self-regulatory process to be evolutionary, not static. OIA currently employs a wide variety of excellent computer programmers to assist their surveillance and investigative efforts. However, those efforts can be enhanced by the addition of new staff dedicated solely to improving existing programs and writing new ones. The Board's approval of five (5) additional programmers will greatly enhance OIA's efforts.

Office Investigations and Audit Enhancements

(9) An increase of OIA personnel by thirty percent (30%) has been approved.

OIA's staff has always maintained the highest degree of professionalism and efficiency. Because training for OIA staff positions effectively occurs only at the Exchange, hiring qualified personnel and training them expeditiously is a constant challenge. The Board has recognized that additional professional personnel to support OIA's efforts will enhance all of OIA's efforts. Therefore, the Board has approved a thirty percent (30%) increase of OIA professional staff over 1988 budgetary levels.

(10) Attorney staff exclusively supporting OIA has been tripled.

The Legal Department of the Exchange provides legal counsel to OIA as it does all Exchange departments. While all attorneys are involved in the self-regulatory process, previously only one attorney was assigned to exclusive OIA liaison and support duties. In consideration of the importance of Exchange disciplinary actions, the Board has approved tripling OIA's legal support to encompass three attorneys whose efforts are devoted entirely to supporting OIA. This increased support will increase the efficient use of OIA staff efforts.

(11) Professional investigative consultants have been approved for OIA training.

Surveillance and enforcement techniques for futures markets are more an arcane art than a precise science. The best training for new OIA staff is by existing OIA staff and Exchange members. Nevertheless, some investigative techniques are common to many markets. Therefore, the Board has approved institution of special training programs in investigation techniques for OIA staff to be conducted by non-Exchange professional consultants. The additional training should enhance OIA's existing excellent investigation efforts.

(12) OIA floor surveillance time has been increased.

Based on the federal investigation into potential floor trading abuses, some question has been raised regarding whether an increased presence of OIA investigative personnel on the Exchange trading floor would enhance detection of trading abuses and provide an increased deterrence to potential abusers. It has been the Exchange's experience that floor trading abuses are rare at the Board of Trade and that when they do occur, they are sophisticated and subtle enough to be detected best by fellow traders and/or sophisticated computer surveillance such as

CTR-PLUS. Nevertheless, the Board has authorized additional dedication of OIA investigators to trading floor presence and observation. Although the returns on such an investment of valuable resources may be small, public confidence in floor trading integrity makes such efforts worthwhile.

Board of Directors Composition

The Exchange's Board is currently a diversified, expert body consisting of twenty-four (24) representatives from all aspects of the membership, industry and general public. The Rules of the Exchange require and foster that diversity. For example, Rule 102.00 requires that the committee which nominates Director candidates "... give special consideration to the desirability of having all interests of the Association represented on the Board." Moreover, the Nominating Committee itself is elected from the diverse Exchange membership which includes individual traders, FCMs, broker-dealers, banks, commercial firms, institutional investors and others.

Thus, the Board of Directors currently is comprised twenty-four (24) members which fall into the following categories:

- (1) three (3) non-members from the general public sector (which have included a former United States Attorney General, a Nobel Prize winning economist, the chairman of a national agricultural association and other similar nationally respected public figures);
- (2) three (3) non-resident members who, being required to have their principal place of business more than fifty (50) miles from Chicago, effectively are quasi-public Directors;
- (3) eight (8) member Directors who are currently principals or officers of member firms and thus represent the FCM/broker-dealer community;
- (4) six (6) Directors whose principal occupation is as brokers executing customer orders on the floor of the Exchange;
- (5) three (3) individual members whose principal occupation is as active traders on the floor of the Exchange for their personal accounts (*i.e.* a "local" trader); and
- (6) the President of the Exchange, a non-member Exchange officer with no vote and no trading privileges.

Thus, the Board is currently very diversified representing all aspects of the industry as well as the general public.

Any criticism of the Exchange's Board as being biased toward members or one aspect of the membership is simply contrary to the facts. Furthermore, present Rules and policies will insure continued diversity of representation; no new rules or legislation are required.

Nevertheless, the Exchange's Board has enhanced its authority and policies in two significant ways.

(13) Board fining authority has been increased more than three hundred percent (300%).

As described previously, the Board of Directors sits as the ultimate disciplinary body of the Exchange, either in an appellate capacity or by referral from a committee. Historically, the Board has always found its authority to suspend, expel and otherwise sanction to be more than adequate. However, with the growth of institutionalized trading and the consolidation of member firms, the Board concluded that its current fining authority (\$75,000 per violation) may not be sufficient in all instances to adequately sanction abuses, especially where larger capitalized respondents are involved. Therefore, the Board increased its fining authority more than three hundred percent (300%) to \$250,000 per violation.

(14) The Board has reaffirmed through formal resolution its long-existing policy of excluding members with histories of significant trade practice abuses from participation on the Board and major Exchange disciplinary committees.

The Board has long had a policy barring members with a history of significant trade practice sanctions from participation on the Board itself or on either of the Exchange's major disciplinary committees, the Floor Governors and the Business Conduct committees. The Exchange is committed to maintaining the utmost integrity of the self-regulatory disciplinary process and those who administer it. To insure that there is no doubt concerning this continuing commitment, the Board has approved a formal resolution approved by the Exchange's Rules Committee reaffirming and formalizing this long-existing policy.

Floor Practice Enhancements

The Board of Trade has historically adopted all its Rules, especially trade practice rules, to meet the highest standards of both integrity and market efficiency. Existing rules proscribe unjust and inequitable trade practices, forbid trading ahead of customer orders, insure that any profit resulting from the erroneous execution of a customer order goes to the customer, prohibit pre-arranged and accommodation trades, as well as prohibit all other forms of trade abuse. The Exchange believes

that these existing Rules are more than sufficient to deal with all potential trade practice abuses. Nevertheless, as part of the on-going review of all Exchange operations, the Board has approved several enhancements to floor practice regulation.

(15) All broker associations must be registered with the Exchange.

Associations of floor brokers sharing profits, expenses and losses -- particularly with the inclusion of local traders -- do not exist at the Board of Trade to the best of the Exchange's knowledge. Such associations do exist at other Exchanges and present those Exchanges with unique self-regulatory challenges to insure market integrity. The potential for abuse of customer orders and market efficiency due to broker groups is, therefore, not present at the Board of Trade.

However, some independent brokers at the Exchange do share order decks to facilitate customer order execution especially in options contracts where liquidity in deep out-of-the-money options is thin. Others share the expense of common clerks. To insure that these arrangements do not evolve into potentially abusive ones, the Board has approved that all associations of brokers which share income must register with the Exchange providing certain information to enhance surveillance of their activities. The Board is committed to preventing any potential abuse of customer orders which would result from the otherwise legitimate business relationships of member floor brokers.

(16) The Exchange has approved a modified closing call rule to enhance the efficiency of the market close.

Market-on-close orders, if entered late, can create problems in achieving an efficient, narrow and accurate closing range. Efficient closing ranges are essential to the commercial usage of futures contracts, especially as a pricing mechanism for cash market transactions. The addition of the modified closing call provides an opportunity for such late entered orders to be completed and for individual floor traders to "even-up" after providing liquidity for closing orders. Also, a more efficient closing range facilitates a more accurate settlement price which frequently is the basis for cash market pricing.

New CBOT Regulation 1007.02 would establish an additional two-minute trading period for all contracts at the conclusion of trading sessions. During this period, transactions could take place only at prices within the previously established closing range. No new orders could enter the pit, but cancellations would be permitted. Stop orders and limit orders elected by the closing range could be filled during this period.

The Exchange believes that the establishment of a modified closing call will benefit public customers for a number of reasons. First, more efficient closing ranges benefit cash market pricing. Additionally, because the new procedure will enable individual floor traders more readily to adjust their positions (to "even-up"), they will be more willing to provide liquidity to the closing public orders at the most competitive prices. Finally, no trade made during the modified closing call would be advantaged over those made previously in the market due to the restriction of prices to those established previously by the closing range.

The Exchange also notes that the audit trail for the modified closing call will be precise because the closing call period will receive a separate CTR designation, thereby enhancing the Exchange's surveillance capabilities for this period.

(17) The Board has approved prohibiting floor clerks from having trading accounts.

Floor clerks are responsible for the clerical handling of customer orders and other trade documents. While having no trading privileges, clerks are nevertheless intimately involved in the trading process. Because of that involvement, clerks are often tempted to trade for their own account. While such trading has historically served as a valuable means of apprenticeship training to become a member, the Board has determined that the rights of membership trading must be restricted to those who pass the intensive membership admission process. Therefore, the Board has approved prohibiting floor clerks from maintaining trading accounts.

Additional Technological Enhancements

The Board of Trade has not limited technological innovation to the creation of CTR and CTR-Plus. The Board of Trade is one of the most technologically advanced marketplaces in the world. Two aspects of that technological supremacy are worth noting in the present context.

(18) The Exchange's electronic order-entry system ("EOS") will not only increase the efficiency of customer order execution and clearing, but also the accuracy of CTR.

For many months, long before the current news of the indictments, the Board of Trade had been developing an advanced, electronic order-entry system ("EOS"). Electronic order-entry will speed communication of customer orders to the trading floor, expedite confirmation of execution back to the customer, and submit trades for clearing directly. These enhanced efficiencies will not only serve customers better and reduce FCM expenses, they

will also provide a computerized record of customer orders with times accurate to the second. This enhanced timing will improve the accuracy of the CTR audit trail and, therefore, the efficiency of the CTR-Plus surveillance system.

Approved by the Exchange membership on November 10, 1988, EOS is now on a prototype basis. As use of the system grows, accuracy of CTR data will be enhanced even further.

(19) The Board has approved further, intensive investigation and development of a hand-held trading terminal.

Just as EOS will enhance customer order time data, a hand-held computer terminal to replace trading cards will provide unimpeachable trade execution timing to the nearest second and perhaps, lead to on-line clearing of trades. Since the inception and commercial availability of hand-held electronic recording devices, both the Board of Trade's and the Chicago Mercantile Exchange's ("CME") technical research and development departments have independently analyzed their practical use on the trading floor. This technical analysis was done to facilitate both the audit trail and also for operational order routing and execution efficiencies. Unfortunately, each new study demonstrated that the technology was not fully deployable. This was due primarily to performance, weight, reliability, and display capacity deficiencies.

Recently, the Board of Trade and the Chicago Mercantile Exchange have announced their joint effort to create a hand-held electronic trading terminal ("AUDIT") which will provide certain, prompt and reliable trade execution times to further enhance exchange audit trails and possibly lead to on-line clearing. The two exchanges have committed five million dollars (\$5,000,000) to this effort which is expected to take several years.

Critically, although improvements in technology and the dedication of joint resources make success a higher probability than before, there is no assurance that such devices can be created in this time frame which meet the demands of market liquidity and efficiency. Thus, the Committee must be circumspect in establishing statutory standards which, in effect, establish deadlines for the invention of products not yet in existence.

JULY SOYBEAN EMERGENCY ACTION

Much discussion - and even more misinformation -- has been generated by the July 11, 1989 Emergency Resolution of the Exchange's Board of Directors regarding the expiration of the July soybean contract. The supreme irony of the controversy is that so much misunderstanding has arisen (often intentionally generated by

special interests) as a result of a contract market performing the duties imposed upon it by an Act of Congress in total cooperation with its governmental agency for the benefit of the market's integrity. Despite this persistence of misinformation, several facts are now crystal clear:

- (1) The Exchange's action was taken in order to prevent the clear and present danger of a disorderly expiration and potential defaults in the July contract;
- (2) There was no disadvantage to farmer/producers in the prices available to them as a result of the order. At the time of the Board's action, the farmers' soybeans were being priced off of the November contract -- not the July contract;
- (3) The CFTC found that no conflict of interest of any sort was involved in the adoption of the emergency resolution; and
- (4) The principal market participant -- Ferruzzi -- has since been subject to at least two public class action civil law suits for market manipulation.

Given these facts, it seems incredible that any "remedial" legislation is thought to be necessary. Perhaps such thoughts stem from a persistent lack of understanding of the facts of the situation. Therefore, to fully understand the July 11, 1989 Board action, it is essential to first review the events that preceded the decision.

As part of its duties as a contract market, the Exchange's mandate is to insure both the orderly liquidation of contracts in accordance with sound commercial practices (17 C.F.R. Section 1.3(z)(1)(iii) (1988)) as well as the contract hedger's obligation to do the same. Section 5(d) of the Commodity Exchange Act (7 U.S.C. Section 7(d)) requires that as a condition for designation as an exchange, the Board of Trade must prevent the manipulation of prices and the cornering of any commodity. Critically, under Rule 542.00, the Business Conduct Committee of the Board of Trade is obligated to prevent market manipulation, corners and squeezes. Most importantly, the Committee is authorized and empowered to insure orderly liquidation of expiring futures contract months.

CFTC Regulation Section 1.41(f)(3)(v) (17 C.F.R. Section 1.41(f)(3)(v) (1988)) empowers contract markets to order the liquidation of contracts and the reduction of positions to deal with emergencies. CBOT Rule 180.00 and Regulation 180.02 specifically empower the Exchange to take emergency action including that required to preserve orderly liquidation. Moreover, CFTC Regulation 1.41(a)(4)(i)(A)-(G) (17 C.F.R. Section 1.41(a)(4)(A)-(G) (1988)) defines "emergency" and CBOT Rule

509.00A(c) prohibits manipulation. Thus, the Exchange is both obligated and empowered to deal with market threats to orderly liquidation.

To understand the events of July, it is necessary to begin at least several months earlier. The May soybean expiration involved a very congested market. The Exchange's Business Conduct Committee was extremely active throughout the expiration with all major market participants and in close contact with the Commission. In the May expiration, all market participants responded to the Business Conduct Committee's market directions. That was clearly not to be the case in the July contract.

Immediately after the May soybean futures contract expired, the Business Conduct Committee began contacting all major market participants, both long and short, to insure the orderly liquidation of the July futures contract. Communication with both long and short participants continued throughout this period on a virtually constant basis (including several times during the trading days as market conditions evolved).

During the month of June, the Business Conduct Committee and staff of the Office of Investigations and Audits closely monitored both futures and cash market activity and expressed increasing concern over the developing circumstances. The Exchange also remained in constant communication with the CFTC throughout this time.

Critically, the cash market pricing went to the November soybean contract rather than the July contract. This extraordinary market development signalled of a lack of market user confidence in July prices. This pricing policy change by cash market participants also insured that farmers selling beans in the cash market were not effected by July prices; the elevator was quoting based on the November contract.

A single market participant, Ferruzzi, held a large portion of the July futures open interest. This included a long position equivalent to 23 million bushels of soybeans and nearly all of the inventory of the registered soybean receipts for delivery at the Board of Trade. On numerous occasions, the Business Conduct Committee and the Office of Investigations and Audits held discussions with Ferruzzi regarding its market activity.

Multiple instances were identified by the staff of the Exchange where cash soybeans were available in several locations at the equivalent or less than the July futures price. Thus, Ferruzzi should have customarily liquidated its position.

During the first week of July, Ferruzzi again appeared before the Business Conduct Committee to discuss its dominant position in the July futures contract, its large holding of registered receipts, and its cash market activities. At the conclusion of that meeting, the Business Conduct Committee directed Ferruzzi to reduce its position substantially or the Business Conduct

Committee would request that the Board of Directors take emergency action to ensure the orderly liquidation of the July soybean contract. Subsequent to that meeting, Ferruzzi failed to reduce its positions in accordance with the Business Conduct Committee's direction.

Unquestionably economic justification existed for the Committee to direct Ferruzzi to reduce its position. On July 10, 1989, outstanding July futures potentially called for the delivery of 40.3 million bushels; yet there were only 12.5 million bushels of deliverable grade soybeans at Chicago/Toledo warehouses. Further, both the long side of the July futures and the deliverable supply of soybeans were held, in large proportions, by Ferruzzi. Finally, the Commission's surveillance staff was concerned with the abnormally large spread between the July and August futures contracts. (On July 10, the July contract was priced more than forty (40) cents higher than the August contract, compared to a difference of only two (2) cents at this time last year).

In a July 10, 1989 response to the Business Conduct Committee's July 7 request to substantially reduce its long July position, Ferruzzi claimed that it was unable to discuss the Committee's decision with its Group Managers throughout the world. Because Ferruzzi did not want its actions to "be construed by the market as being overly aggressive, ... artificial and manipulative," it refused to comply with the Committee's request and instead threatened to "use any means at its disposal to recover all damages incurred due to such action."

As a result of Ferruzzi's failure to reduce its holdings, the Business Conduct Committee recommended to the Board of Directors that the Board exercise its emergency authority to ensure the orderly liquidation of the July soybean contract.

Unbeknownst to the Exchange until the morning of July 11, 1989, the Commission on July 11 notified Ferruzzi that the Commission would not consider any positions held as anticipatory hedges to be bona fide hedges as of July 18, 1989. The effect of this notification was that Ferruzzi had to reduce its positions from 23 million to 3 million bushels in a matter of days.

The notice for an emergency Board of Directors meeting was posted on Tuesday, July 11, 1989, one hour before the scheduled Board meeting (as required by CBOT regulations). The subject of the call was "expiring futures." The meeting convened at 2:15 p.m. (CDT) as scheduled. As the first order of business for the Board meeting, each and every individual Director was asked whether they owned or controlled any positions in July soybeans. One Director who answered affirmatively immediately left the meeting. Nothing regarding the July soybean expiration was shown to or discussed with any board member (except the Chairman and the President who do not vote) prior to the polling of each Director for any potential conflicts of interest.

After considering its responsibilities and all circumstances surrounding the July contract (including the aforementioned action taken by the CFTC), the Board determined that the July soybean market was seriously threatened with the potential for a major market disruption, including the lack of orderly liquidation and possible defaults on the contract. In the Board's opinion, both the devastating, long-lasting impact of such a disruption and its general effect on market participation, heavily outweighed the potential ramifications of taking emergency action.

The action taken by the Board was market neutral, effecting both long and short participants and providing for a gradual reduction of positions. The Board's action was subsequently fully validated by the CFTC, which reported that there were neither improprieties nor any conflict of interest present in the Board's decisionmaking on July 11. The CFTC specifically concluded on August 25 that:

1. There were market indications of an imminent disorderly liquidation in the July 1989 soybean contract. The CFTC and the Exchange conducted extensive and coordinated surveillance of the May and July 1989 soybean expirations.
2. The Ferruzzi "group" held the preponderance of positions on the long side of the market and in addition to most of the soybeans in position to deliver on the contract. On three occasions, the CFTC wrote to Ferruzzi expressing its concern regarding the orderly expiration of May and July soybean futures contracts. On two occasions, the Exchange's Business Conduct Committee wrote to Ferruzzi also expressing its concern regarding the expiration of the July soybean futures contract, in addition to having Ferruzzi make several Committee appearance's on this matter. Ferruzzi's response on July 10 demonstrated the trader's apparent unwillingness to cooperate to ensure orderly liquidation of the July futures;
3. The CFTC found no members of the Exchange's Board of Directors to be in conflict of interest. Neither did the CFTC find any board member to have traded for the purpose of profiting personally, or through an affiliated firm, from prior knowledge of the July 11 order;
4. The emergency action is not likely to have any significant or long-term impact on the price of soybeans to producers or consumers because most cash prices were already being priced off the November futures contract at the time of the action and because the action did not alter the fundamental demand for soybeans. Furthermore,

the sharp drop in prices for new crop futures after July 14 was in response to beneficial rains in U.S. soybean growing areas and to favorable supply developments in Brazil; and

5. The fact that the exchanges have the authority to take emergency action as a last resort lends credibility and strengthens these informal measures and usually makes emergency action unnecessary. It would be unwise to constrain the ability of the exchanges to respond quickly when serious problems arise.

The current Senate bill, however, appears to ignore the CFTC's findings and, instead, proposes legislation specially focused on requiring the futures industry to pay the price for Ferruzzi's failure to obey both Exchange and CFTC directives and regulations. Such provisions are counterproductive: they punish contract markets for fulfilling Congressionally mandated responsibilities as well as counteract the public interest served by the Board's decision. Legislation on such critical industry issues as conflicts of interest and disclosure is simply unwarranted by the facts of the July soybean order.

S.1729: FUTURES TRADING PRACTICES ACT OF 1989

S.1729, the Futures Trading Practices Act of 1989, is offered by Chairman Leahy as a bipartisan effort with one goal: to "design a workable system that is efficient, effective and fair." The Board of Trade shares and fully supports the Committee's goal of achieving efficient, effective and fair legislation. Anything less would be a disservice to the American people and economy since it would ensure the demise of the United States futures industry to the benefit of burgeoning foreign markets.

The Board of Trade supports some of the provisions of the bill virtually as written. With respect to other critical provisions, however, the Exchange believes that our common goal of efficiency, effectiveness and fairness will be best achieved by alternative statutory language and/or approaches. The following summarizes each provision of the bill accompanied by specific comments and suggestions.

TITLE I - AUTHORIZATION OF APPROPRIATIONS

SECTION 101 - The bill authorizes a sixty percent (60%) increase for the CFTC over the next five years (from \$41 million in 1990 to \$66 million in 1994).

COMMENT: The Exchange has no comment on the specific authorized levels of CFTC budget as provided. However, the Exchange questions whether five years of appropriations at one time diminishes the bill's flexibility; perhaps a shorter provision (*i.e.* for two years) would provide the Committee greater oversight flexibility.

TITLE II - SURVEILLANCE AND DUAL TRADING

SECTION 201 - Duties of Contract Markets. The bill requires that contract markets "maintain and utilize" audit trail systems "to monitor trading to detect and deter violations" of the Commodity Exchange Act "related to the making of trades and the execution of customer orders on the floor." Upon enactment, the system would have to accurately record "the times of trades in increments of no more than 1 minute in length" and to sequence trades "for each floor trader and broker."

Three years following enactment, the audit trail system must record all trades accurately and promptly: (1) by a source both "independent of the person making the trade and continually recorded in the record of the contract market", and (2) "with precision adequate to determine the sequence of all trades by each" floor trader/broker and, to the extent feasible as determined by the CFTC, all trades in general. In addition, the audit trail system must, to the extent feasible as determined by the CFTC, record customer orders "by a source independent of persons processing or executing" the order: (1) the time each order is received on the floor of the exchange and is reported from the floor as executed with precision adequate to determine the trade sequence for each FCM or floor broker; and (2) the time each "order is received by the floor broker with precision adequate to determine" both the sequence and the interval of time between receipt and execution by the broker.

COMMENT: Initially, the bill is written to require contract markets to enforce the Act rather than its rules and regulations. This is an apparent oversight in the drafting process.

Throughout the Act's history, contract markets have been required to enforce their rules and the Commission has fulfilled the responsibility for enforcing the Act. Regarding many provisions of the Act, this distinction is moot since contract market rules are substantially similar, if not identical, to the provisions of the Act. However, it obviously serves no purpose to provide that contract markets have enforcement responsibility for provisions of the Act over which they have no involvement or control (such as the conduct of introducing brokers). Therefore, changing the language of Section (13)(A) to provide that contract markets' audit trail systems detect and deter violations of "the contract market's rules and regulations" rather than "this Act" conforms the bill to the Act's differentiation of contract market and Commission responsibilities.

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Moreover, as detailed previously, any analysis of audit trail standards must begin with the following factual premises: (1) the Exchange currently employs the world's most advanced audit trail system; (2) has achieved numerous improvements in technological oversight; (3) continues to seriously commit vast resources to reach the goals proposed in this section; and, (4) presently is in substantial compliance with the proposed one-minute recording standard for the timing of trades. Thus, our common goal should be to improve existing excellence, not mandate the unattainable.

The Exchange fully supports the bill's objectives to sequence all transactions to the extent feasible. The Exchange currently requires traders to record their transactions in exact chronological sequence within a trading card. The Exchange also has an audit program that checks the sequence of a member's trading activity. This program relates the member's personal trading sequence to a Sequence and Sales Journal. Members are subject to disciplinary action for improper sequencing of trades.

While the Exchange supports the goal behind these standards, those requirements cannot be absolute. The current statutory language of the bill could be misread to require standards of perfection unobtainable in reality. Instead, the bill should be modified to reflect the objective of excellence shared as a goal by Congress, the CFTC and the entire futures industry. Those standards should take into account current technology and should only require those efforts that are humanly possible based on that technology.

Specifically, to require that the broker independently time the receipt of a customer order in hand would irreparably damage the United States futures industry. Applied literally, this requirement would eliminate all flashing of orders from floor clerks. Research to date indicates that no available technology is faster than flashing for the communication of orders to the broker. Eliminating flashing would substantially slow down the time necessary to execute trades, as proposed by both the sequencing requirement as well as the continually recording mandate stated in this section. Vital markets -- especially the United States Treasury bond contract -- would be unacceptably handicapped in aiding our economy's efforts to compete with the virtually unregulated foreign competition.

Improvements and enhancements to the audit trail system are possible and are being implemented continuously. These enhancements will achieve the bill's objective of improved audit trails without presenting the potential for the destruction of contract liquidity. The following is a detailed description of an extensive program of such audit trail enhancements already being implemented by the Exchange:

1. EOS

EOS is an electronic order delivery system which routes customer orders from the member firm offices to a trading pit on the floor of the Exchange. Under EOS, the customer's order would be timed upon entry in the sales office, upon receipt on the trading floor, and promptly after execution by a floor broker. A secure and unalterable record of these times is created by EOS. EOS is presently operational on a pilot basis during the Board of Trade's evening session and will shortly be implemented in our daytime trading session.

2. Broker Workstations

The Board of Trade is in the process of developing broker workstations which involve a computer terminal through which floor brokers would manage their decks of orders. EOS would flow directly to the broker workstations. The receipt and reporting of executed transactions as well as the timing of such transactions would also flow through the broker workstations.

However, the Exchange is fully aware the broker workstations may prove to be unfeasible in high volume markets. Moreover, it is clear that based upon present technology, flashing is a quicker, more efficient means of order communication which insures tremendous cost savings to market users. Therefore, the universal requirement of broker workstations under current technology would be counterproductive to market quality.

3. Hand-Held Terminals

The Board of Trade, in conjunction with the Chicago Mercantile Exchange, has committed \$5 million to the research and development of hand-held computer terminals. The hand-held terminal are intended to allow floor brokers and traders to record all floor transactions promptly upon execution, time such transactions, and transmit data for matching and clearing purposes. A joint committee of each exchange is actively pursuing the specifications required for such terminals. We will keep the Commission informed of progress in that endeavor.

However, these technological enhancements may take some time to develop and implement. As importantly, it is not yet clear what impact such enhancements will have on the functioning of open outcry markets. Certainly, such technological enhancements should provide an audit trail superior to any in existence today. In the interim, however, significant improvements in the audit trail are already taking place, including the reprogramming of CTR computer logic, narrower bracketing and recording requirements for member transactions, and tighter timing and recording requirements for customer orders.

Foreseeably, the requirements enumerated in the current wording of this section of the bill could only be met by (a) a hand-held terminal or (b) computerized trading. As previously discussed, although the Exchange is committed to developing such technology, to-date such technology is simply non-existent.

The three-year timetable of this bill would compel the entire futures industry to trust its future to technology as yet undeveloped. As stated earlier, the Board of Trade shares this Committee's desire to have the best audit trail obtainable which does not negatively impact the functioning of the market. Requiring standards unobtainable by present technology only sets up the marketplace for failure, to the detriment of all involved. Deferring the requirement by three years provides no solution because there is no assurance that technology will develop sufficiently in the interim to meet the proposed standard.

The bill's objectives would be better served by simply requiring that the audit trail be sufficient to properly monitor the market and detect potential trading abuses. The SRO's and the CFTC are in the best position to determine the particular specifications which achieve that requirement. This Committee, through periodic oversight reviews, can then monitor the progress of audit trail developments as they occur.

SECTION 202 - Commission Oversight; Deficiency Orders. The bill provides that "[N]ot later than 1 year after of the date of enactment" and "at least once every 2 years thereafter", the CFTC "shall assess" how contract markets detect violations.

If it finds the exchanges have failed to demonstrate sufficient "trade monitoring systems," the CFTC can order the exchanges to: (1) "institute appropriate improvements in its trade monitoring, compliance, or disciplinary systems necessary to bring such systems into compliance"; (2) "employ additional staff, upgrade or reconfigure existing systems for collecting or processing relevant data on trading and trader or broker activity, or deploy such systems"; and (3) "suspend the privilege of dual trading."

Additionally, dual trading shall be suspended unless the contract market either (1) demonstrates it "fully satisfies the audit trail standards" or (2) shows "the substantial likelihood that a suspension would harm the public interest in hedging and price basing."

The CFTC may also remove any "named officer, director, committee member or employee" for "willfully" failing to fulfill official responsibilities, abusing authority or performing acts rendering a person otherwise unfit for official service.

COMMENT: Examination of the Commodity Exchange Act and CFTC regulations reveals that the CFTC's powers are presently more extensive than those of other market regulatory agencies. With respect to CFTC resources, the Board of Trade has always supported necessary CFTC requests for additional staff or technological resources and will continue to do so in the future.

The bill as proposed, however, greatly expands the CFTC's power to compel exchanges to commit unlimited resources without adequate opportunity for hearing. While the intended goals are laudable, there is no need for additional modifications of the current regulatory machinery. However, to the extent any are enacted, the basic procedural safeguards of hearing and appeal must also be provided.

Initially, Section 8(e)(b) establishes an inverse burden of proof. It provides that Commission deficiency orders should issue when the contract market has failed to demonstrate compliance. The minimal requirements of due process mandate that such orders issue only after the Commission, in an evidentiary hearing, proves that the contract market has failed to demonstrate compliance.

Further, Section 3(D) proposes to grant the CFTC authority to suspend dual trading, possibly for a "deficiency" wholly-unrelated to any actual dual trading problem. The "punishment must fit the crime," and such legislation is certainly neither rationally related nor the least restrictive means to the goal it intends to achieve. At a minimum, the provision should require the Commission to demonstrate a causal connection between the "deficiency" and its relation to potential dual trading abuses.

Moreover, a ban on dual trading for failing to meet the legislation's goals is unjustified. "Banning dual trading doesn't really solve the problem of trading abuses," stated Richard Fogel, Assistant Comptroller General of the GAO, (See Kevin G. Salwen, "Bill on Oversight of Commodities Cleared by House," Wall Street Journal, September 14, 1989.) Fogel observed that some of the traders recently indicted by the United States Attorney in Chicago allegedly used third parties, rather than dual trading, to execute illegal transactions. "Restrictions on dual trading are no substitute for precise, complete and independent timing of trades," Fogel further stated.

The Exchange is currently implementing state-of-the-art technology to more precisely time trades the academic consensus of the positive benefits of broker trading. These steps, detailed supra, in conjunction with the academic consensus of the positive benefits of broker trading further militate against arbitrarily curbing dual trading.

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The bill also creates a new CFTC power granting the Commission authority to remove any officer, director, committee member, or employee for (1) failing to fulfill his or her "official responsibilities"; (2) abusing his or her authority; or (3) acting in an unfit manner. These vague standards imbue an unprecedented and unwarranted amount of discretion in the CFTC. Moreover, the motivation for the provision is questionable, if not mysterious. The Exchange is unaware of any instance of contract market officers failing to perform their duties. Exchanges are already liable for the acts and omissions of their management. There simply is no need for this provision.

If this removal provision remains in legislation, it must at least must provide for federal court review of any CFTC or Administrative Law Judge proceeding to check the potential abuse of discretion. The judicial review provided for under subsection (f) only involves final orders. The Exchange submits that judicial review of CFTC actions is necessary before an order takes effect to insure adequate protections of due process.

SECTION 203 - Oral Orders. Subsection (g) provides that "[t]he placing of oral orders on contract market floors for member-for-member trades shall be barred unless such orders are made pursuant to rules that the Commission adopts and certifies to Congress."

COMMENT: If "oral" orders include flashed orders, such a prohibition ignores the beneficial purpose oral orders serve in the trading of futures and options on futures contracts. The vast majority of financial contract orders are flashed. Moreover, virtually all hedging from options to futures contracts is done by flashing. To eliminate such orders would damage both the efficiency and the liquidity of the markets.

If oral orders present a potential problem for rule enforcement, the Board of Trade has not experienced such problems. Therefore, requesting the CFTC to study and promulgate rules regulating oral orders would be preferable to an unstudied and potential devastating outright ban of all oral orders.

TITLE III - BROKER ASSOCIATIONS

SECTION 301/SECTION 302 - Trading Restrictions: Disclosure. Section (3)(A) provides that "a floor trader or floor broker may not make a trade or execute an order of a customer if such trader or broker knows the opposite party to the transaction to" have a relationship either as a partner or employer/employee to such broker or trader. Moreover, "any trade, business, or financial association, affiliation, partnership, cost-, profit-, or capital-sharing agreement, or other formal or informal such arrangement" must be disclosed to the exchange or Commission.

COMMENT: Broker associations have received particular attention of late. However, there has been no definitive study of their prevalence, structure, and impact on futures markets.

While common in some markets, broker associations (as commonly understood) are not prevalent at the Board of Trade. Nevertheless, the broad, unrestricted statutory language of the bill could prohibit trading by members with perfectly legitimate non-trading business or with minimally-relevant relationships (such as the employment of a common trade-check clerk to minimize expenses.)

Rather than make a draconian proposal to address a potential problem whose dimensions are unknown, the marketplace would be best served by mandating the Commission to study broker associations, report to Congress, and promulgate rules if found to be necessary. Indeed, the Commission is in the process of such rulemaking currently.

TITLE IV - GOVERNING STRUCTURE

SECTION 401 - Governing Structure. Section (15) requires a "meaningful representation on the governing board" of the exchange including FCMS, floor brokers, traders, and producers, consumers, processors, and distributors of major commodities traded on the Exchange. It further requires that no less than twenty percent (20%) of the Board be comprised of non-members, either experts in futures trading or otherwise eminently qualified.

Section (16) provides that major disciplinary committees have a "diversity of membership sufficient to ensure fairness and to prevent special treatment." It further provides for notice to the "ultimate customer" of any disciplinary action resulting in financial harm to a customer.

Section (17) provides that board and committee members must recuse themselves where: (1) the member or any business affiliate of the member has virtually any interest in the matter at issue; and (2) where any rule or order "is likely to affect prices" specific disclosures must be made and recorded and undefined measures taken to insure no abuse of material, non-public information.

Section (18) prohibits (only) members from serving on "oversight or disciplinary" panels if the member has violated any provision of the CEA or any other law "that would reflect on the fitness of the member to serve in a fiduciary capacity" for a period of time to be proscribed by the Commission.

COMMENT: The Exchange has no objection to requiring a diversified board composed of representatives from all aspects of the industry. As detailed supra, the Exchange's Rules currently provide for such diversity, and the current composition of the

Board reflects that. Additionally, the Board has already expanded (subject to membership's approval) the number of non-member public directors on the Board from three to four and extended their terms of service from three to four years.

The requirement of Section 16(B) that "qualified" non-members serve on major disciplinary committees "where appropriate" is much too ambiguous to be implemented by the Exchange. Section 16(B) is superfluous given the mandate of 16(A) to ensure fairness; it should therefore be deleted from the bill.

This section also states that an exchange must notify the "ultimate customer" of a disciplinary action. This requirement should be modified to state that an exchange should notify the FCM, who in turn must notify the customer. Alternatively, the bill could require notification of a customer only where that customer is reasonably identifiable by the Exchange. For example, notice to the "ultimate" customer would be impossible in the instance of a foreign, omnibus account where the ultimate customers are unidentified entities in foreign countries.

The legislation also attempts to prevent any possible conflict of interest in exchange emergencies (such as the July Chicago Soybean order.) While the bill's conflict of interest procedures illustrate a meritorious goal in prohibiting exchange board or committee members from voting on a rule if they had a direct financial interest in the subject, the provisions as drafted would make it impossible for members of board of directors and committees to govern the Exchange. The goals intended by the legislation, however, are clearly and adequately illustrated in the current process used by the Chicago Board of Trade in calling special Board meetings and taking emergency actions. This process reflects policies and practices set forth in the Commodity Exchange Act, CFTC Regulations and CBOT Rules, regulations, policies and practices. (See Appendix 5).

The very real danger inherent in the bill's standard is that a conflict exists by the partial and indirect knowledge of a Director of his affiliated firm's positions. This perceived bias could disqualify virtually all Directors save for both those local traders not trading on a given contract and the public directors without any position holdings. Accordingly, deciding a self-regulatory organization's most serious actions could be relegated to those furthest removed from the experience involved in that particular action. Such a result is certainly counter to the public interest.

The conflict of interest provisions in the bill constitute an unworkable standard during an emergency. First of all, the procedures involve any order "likely to affect prices in any actively trading contract market." This incredibly vague standard leaves it totally undetermined under what precise circumstances

the Board must take certain action. Moreover, while we agree in principle with the necessity of disclosure, the bill as provided adds a time element which could severely hamper the Exchange's ability to make important and quick policy. Finally, the disqualification from oversight panels of members who have violated "any other provision of law that would reflect on" the member's fitness is impermissibly vague, overbroad and incapable of enforcement. (Moreover, as drafted, it applies only to members, not non-members). This standard would remove members from deciding important resolutions for such minor infractions as routine recordkeeping violations.

Provisions with as serious impact as these should not be hastily considered. Recently, in a speech at a law conference in Strasbourg, France, CFTC Commissioner Robert Davis questioned the premise behind the proposed conflict of interest provisions. Noting that the CFTC found no misuse of proprietary information by CBOT Board members who voted on the soybean order forcing the liquidation of large positions, he concluded no such provisions were necessary. We agree.

The detailed provisions already in place are more than adequate to meet the most stringent standards. Alternatively, if any legislation is deemed necessary, it should be to codify the existing Rules and procedures detailed in Appendix 5.

TITLE V - FLOOR TRADER REGISTRATION

SECTIONS 501-503 - Definition and Registration of Floor Traders. These sections define floor trader as "any person who, in or surrounding any 'pit', 'ring', 'post', or other place provided by a contract market for the meeting of persons similarly engaged, purchases or sells solely for such person's own account any commodity for future delivery." The section also requires that floor traders register with the CFTC or NFA.

COMMENT: The Exchange has no comment at this time regarding these provisions of the bill.

TITLE VI - PENALTIES

SECTIONS 601-606 and 608-610 - Penalties and damages sections.

SECTION 607 - This section makes it a felony "for any person knowingly and willfully to falsify, conceal, or cover up" any material fact or make any false statement to a SRO. The CFTC may assess fines against rule violators the higher of \$100,000 or triple the monetary gain per violation. The criminal penalties may be extended to those who "willfully" provide false information to SRO's or who "willfully" violate CFTC rules.

COMMENT: The CBOT believes that the CFTC presently has sufficient sanctions to deter unlawful trading activity. The CFTC already has substantial penalties in the statute which it can impose on

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violators. Congress must keep in mind that the current system of discipline of Exchange members involves at least three separate "regulators." The Exchange can sanction a trader, the CFTC can sanction a trader and the Justice Department can bring criminal charges, either at the request of the CFTC or of its own volition. In addition, futures industry participants currently can be sued in civil proceedings. Finally, the CBOT's Board of Directors recently has increased the Board's fining authority from \$75,000 to \$250,000 per violation, more than tripling its past fining authority.

We would suggest, therefore, that sufficient sanctions, penalties and potential jeopardy currently exist to sufficiently deter futures markets participants from violating the existing regulatory structure.

To the extent the Committee deems it necessary to provide further public protection, we submit that requiring contract markets to establish procedures for customer claims where customer harm has been found in an exchange disciplinary action will better serve Congressional intent. Such "restitution" could be required by the disciplinary order as fines are now; the resulting funds could then be held in escrow pending notification of effected customers and the filing of customer claims. The exchanges have the necessary resources to establish such procedures with modifications to existing procedures. Such an approach would do far more for public protection than increased penalties.

At a minimum, should the provisions of Section 607 remain, the "willful" standard needs to specify that true scienter is required, namely, that violators must have had a clear, conscious, specific intent to break the rules to be convicted of a felony.

TITLE VII - ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

SECTIONS 701-707 - Assistance to foreign futures authorities.

COMMENT: The Exchange has no comment at this time regarding these provisions of the bill.

TITLE VIII - GENERAL PROVISIONS

SECTIONS 801 - Ethics Training for Registrants. The bill requires the CFTC to "issue regulations to require registrants, within 6 months after receiving such registration, to attend a training session, and all other registrants to attend periodic training sessions, [and] to ensure that registrants understand their responsibilities to the public."

COMMENT: The CBOT agrees in principle with heightening the awareness of its members to issues of ethics. The Exchange currently has twice-monthly seminars for new members to increase

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consciousness of and commitment to ethical values by our membership. The Exchange has lengthened the seminar by 50% to a full day and has used a new "Statement of Ethics" in teaching our Rules and Regulations to new members. We are currently contacting professors and various universities both to better understand the current scope of courses and other offerings in business ethics and to seek suggestions from them as to how the Exchange can best develop programs for the membership.

Moreover, on August 15, 1989, the CBOT established a permanent Committee on Ethics and Integrity. This Committee has been created to examine all aspects of exchange trading practices and trading operations to ensure the utmost of integrity and ethical conduct of trading including, but not limited to, the proposal of rules and regulations.

The efforts taken by the Exchange both towards self-regulating the ethical education of its members as well as establishing a permanent Committee clearly demonstrate that the "mandatory training for registrants" as proposed in the bill is not necessary.

SECTIONS 802, 804, 805, 807 and 808 - Undercover operations and enforcement; Enhancement of registration requirements; Hiring and compensation authority of Commission; Appeals by registered futures associations; Telemarketing fraud.

COMMENT: The Exchange has no comment at this time regarding these provisions of the bill.

SECTION 803 - Access by GAO to Information Maintained By Self-Regulatory Organizations. The GAO shall have access "to and the right to examine all records and other recorded information, in any form, and to examine any property that is within the possession and control of any contract market, clearinghouse, or registered futures association... or of a firm that provides computer services to such" SRO.

COMMENT: There is no need for GAO to obtain directly such extremely confidential information at will from the SRO; such information can, under proper circumstances, be obtained from the CFTC. The Commission currently has the subpoena authority to review and audit all records and property within the control of any SRO. The Exchange routinely discloses business transactions, market positions, trade secrets, and customers' names pursuant to CFTC request. Expanding this right of access to the Comptroller General of the GAO is, therefore, unnecessary and may increase the inadvertent disclosure of this vital, confidential data. The provision is, therefore, not necessary and creates a real threat of lost market user confidence in the confidential status of its most vital business information.

SECTION 806 - Service Fees. The bill expands the CFTC's existing authority to charge service fees. Section (2) provides "such fees shall reflect the cost" to the CFTC of (1) "monitoring trading on the floors of designated contract markets to prevent and deter violations;" (2) "supervising contract markets, futures associations, leverage transaction merchants, and other registrants to ensure compliance with self-regulatory standards"; (3) "analyzing and designating new futures, option or leverage contracts"; and (4) "such other services, activities, and functions" as the CFTC finds appropriate.

COMMENT: The Exchange vehemently objects to a thinly-disguised transaction tax which could fund the entire (\$66 million) CFTC budget given the breadth of the current statutory language. This will only increase the cost of doing business and thus make the entire U.S. futures industry less competitive internationally.

The Exchange is currently spending many millions of dollars to achieve the statute's goals over the next three years. In 1988, the Exchange paid the CFTC approximately \$155,600 in service fees. In addition, the National Futures Association ("NFA"), which is completely funded by the futures industry, had a \$21 million budget in 1988; because the NFA both monitors and regulates the industry, its budget represents a savings of that amount to the CFTC budget. Therefore, Congress should defer imposing service fees and reevaluate them after further GAO reports are submitted to the Committee.

The current Commodity Exchange Act's provisions concerning a contract market's payment of the Commission's expenses are more than adequate to serve the purpose of the bill. As is, each exchange must pay the Commission's actual costs in conducting contract market rule enforcement and financial reviews. This would appear to cover the expenses proposed in Section 806(b), (c) and (d) of the Senate bill. The additional fee proposed regarding the additional cost of monitoring trading on the floors of exchanges to prevent abuses of the act could be construed to be the entire CFTC budget. The imposition of such fees can only make the domestic futures industry less competitive when compared to the virtually unregulated foreign market.

The availability of so many other methods and locations to conduct risk management of the futures industry means that any increase in the costs of using one of these vehicles such as service fees can result in a huge disadvantage relative to the competition. This high degree of competition means that market users benefit as each provider must keep its costs low. Conversely, any regulations that increase the cost of using futures markets will put the U.S. futures industry at a competitive disadvantage. Moreover, the burden of these costs will be borne by the ultimate users of risk management services: grain producers and handlers, pensioners, savings account holders and other who benefit from using futures to hedge risks.

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Experience has demonstrated that those who use futures markets to manage their risk are extremely sensitive to increases in the cost of using U.S. futures markets; they are quick to switch to foreign markets if American markets become more costly to use. This sensitivity to cost increases is particularly pronounced in the new and less active futures markets where the U.S. cost advantage is small.

The damage an increased service fee can do to a futures market is well documented in the case of the S.O.F.E., a formerly successful but now defunct futures exchange in Sweden. Many experts agree that the Swedish transactions tax initiated at the beginning of 1989 raised the cost of using that exchange so much that its customers simply took their business elsewhere. (See Euromoney, March 1989, pp. 49-50.) Clearly, a substantially increased service fee could spell the end for some U.S. futures markets. Higher operating costs through payment of service fees means higher prices to those who use futures markets. Foreign futures markets and unregulated risk management tools will undoubtedly become more attractive. One American industry which still remains the envy of the world financial industry will have its competitive advantage unnecessarily eroded.

SECTION 809 - Venue and service of process section.

COMMENT: The Exchange has no comment at this time on these provisions of the bill.

SECTION 810 - Study of Delivery Points for Agricultural Commodity Contracts. The Comptroller General "shall conduct a study of the provision for, and functioning of, delivery points regarding contracts of sale for future delivery of any agricultural commodity." GAO is also to study cash settlement and international market issues.

COMMENT: A study of multiple delivery points is currently being performed by GAO. The Board of Trade has already begun meeting with GAO in cooperation to assist them in their study. Thus, the specific provisions of the bill are not necessary and should be deleted.

In addition, the Board of Trade has continuously studied this issue in depth: (1) 1980 - "An Evaluation of the Delivery Points for the Soybean Futures Contract" was prepared and submitted to the CFTC on November 26, 1980; (2) 1981 - A Special Committee on Great Lakes Delivery Points reviewed grain delivery points and differentials; (3) 1982 - A Special Committee on Delivery Points the delivery system for all Board of Trade agricultural contracts; (4) 1985 - A Special Committee on Agricultural Regularity reviewed the grain delivery system; and (6) 1989 - The Grain and Oilseed Executive Committee of the Exchange is currently reviewing the Exchange's grain contracts. The Economic Analysis department of

the Exchange has conducted studies of the Wheat, Corn and Soybean markets to assist the Committee in its review. The Exchange anticipates continuation of these extensive studies with full industry input.

The Exchange's experience with these studies demonstrates the complexity of the issue. For example, multiple delivery points have been argued by some as destructive of accurate price discovery; multiple points cause futures contracts to price off the cheapest delivery point rather than reflect the overall market. The result may well be lower prices paid to producers. Thus, expansion of delivery points may benefit only the corporation owning the expanded delivery point, not the producer, consumer and other users of the market.

While Congressional concern over contract performance is warranted and laudable, focus on this one issue appears to arise from the false accusations surrounding the Board of Trade's July 11, 1989, Emergency resolution regarding the July soybean contract. As detailed above, reliance on those accusation is unfounded and dangerous. An objective study by GAO should place those accusations in their proper perspective with finality.

Rather than adopt the specific provision of this bill, the Committee and the public will be better served by the Committee reviewing the result of the GAO study currently in process to determine if more research is necessary.

TITLE IX - EFFECTIVE DATE

SECTION 901 - This Act becomes effective upon enactment.

COMMENT: The Exchange has no comment at this time on this provision of the bill.

CONCLUSION

The combination of sophisticated computerized surveillance systems and the vested self-interest of the Exchange's rigorously screened membership combine to create an extremely effective mechanism for the detection of potential exchange trading floor abuses. The Board of Trade has never condoned -- and does not condone today -- any trade practice abuse. Proven offenders have always been appropriately sanctioned (including fines, suspensions and expulsions).

Nevertheless, the Board of Trade recognizes that success is an evolutionary process, not a static one. Thus, despite creating CTR and CTR-PLUS -- the world's finest audit trail and surveillance systems -- the Exchange has considered all means to preserve and improve market integrity. The result of the most recent, intensive internal study is the nineteen (19) point program of enhancements detailed herein. These improvements (and others still under consideration) will insure that the Board of Trade's markets remain the world's most efficient, liquid and economical with the highest degree of integrity and professional participation.

In considering these issues, we urge this Committee to remain mindful of the potential (indeed, likely) consequences of precipitous, hastily considered action. While currently the world leader in futures markets, the U.S. could easily lose this unique and valuable industry to eager foreign competitors, if ill-considered regulation is mandated. Therefore, critically valuable trade practices such as broker trading must be carefully evaluated, especially where their value is indisputably documented and no evidence exists regarding any abuses.

In fashioning any legislation, this Committee should also look with pride to the precedent set in 1986 regarding the audit trail issue. Then, the CFTC goal of one-minute time identification was left to each separate exchange, with its differing membership and markets, to best determine how to meet that goal. The result of this management-by-objective approach was the creation of CTR, the world's finest audit trail. If Congress acts similarly now after careful study, the result should be the continued improvement of what are already the world's most honest, liquid and efficient futures markets. This is the goal we all share.

Several of the provisions of S.1729, especially those relating to audit trails and service fees, appear ill-conceived to achieve the stated objectives of the bill, objectives shared by the Board of Trade. However, with some modifications to key provisions, everyone's common objective of market integrity and liquidity can and will be achieved.

APPENDIX 1

TABLE 1

Volume Growth Rates: U.S. and World Futures Exchanges;
1984-1988

	<u>Average Daily Volume</u>		<u>Growth Rates</u>
	<u>1984</u>	<u>1988</u>	(%)
CBOT	295,147	563,144	90.8
Other U.S. Futures Exchanges	335,865	599,839	78.6
Foreign Futures Exchanges	152,000	495,549	226.0
U.S. Market Share	80.6%	71.7%	
Foreign Market Share	19.4%	28.3%	

FIGURE 1

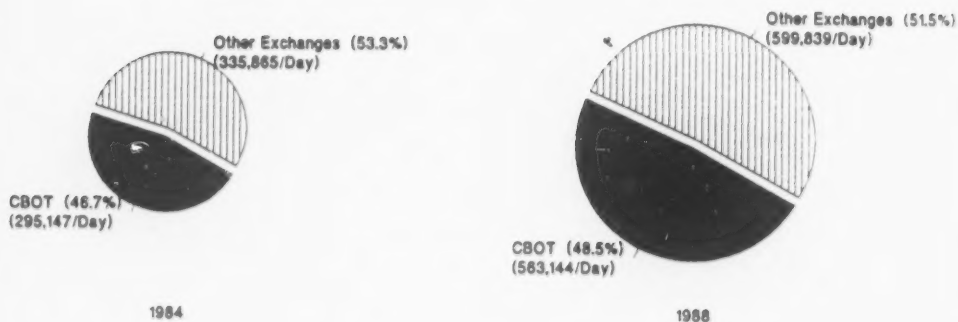
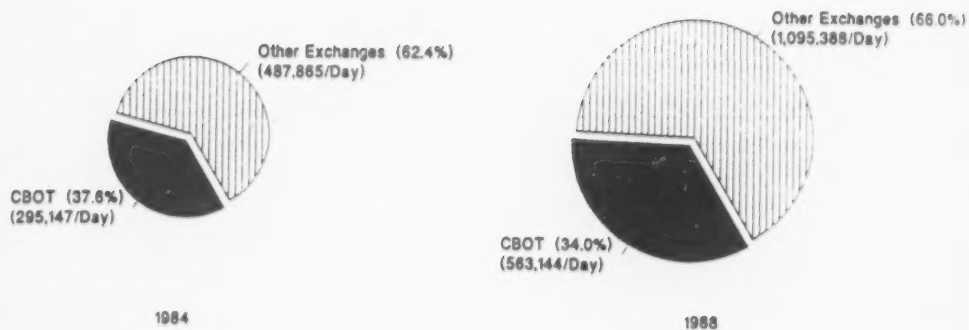
**CBOT Market Shares of U.S. and World Futures
and Futures Options Volume; 1984 vs. 1988****U.S.****WORLD**

TABLE 2

Contracts Trading at the World's Futures Exchanges

<u>U.S. Futures Exchanges</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1989</u>
No. of Contracts Listed	94	108	120	124	130
Growth Rate (%)		14.9	11.1	3.3	4.8
 <u>Foreign Futures Exchanges</u>					
No of Contracts Listed	125	129	172	178	223
Growth Rate (%)		3.2	127.7	3.5	25.3

TABLE 3

TEN MOST ACTIVELY TRADED CONTRACTS ON FUTURES EXCHANGES WORLDWIDE

1985-1989		1989*	1988	1987	1986	1985
Rank						
1	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES
2	Chicago Mercantile Exchange Eurodollars	Chicago Mercantile Exchange Eurodollars	Chicago Mercantile Exchange Eurodollars	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange S&P 500 Futures
3	NY Mercantile Exchange Crude Oil Futures	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Board of Trade TREASURY BOND OPTIONS
4	Chicago Board of Trade TREASURY BOND OPTIONS	NY Mercantile Exchange Crude Oil Futures	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange Eurodollar Futures
5	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	NY Commodity Exchange Gold 100 oz.
6	MATIF French Government Bonds	Chicago Board of Trade SOYBEAN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	NY Mercantile Exchange Crude Oil Futures	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade SOYBEAN FUTURES
7	Chicago Board of Trade SOYBEAN FUTURES	MATIF French Government Bonds	MATIF French Government Bonds	MATIF French Government Bonds	NY Mercantile Exchange Crude Oil Futures	Chicago Mercantile Exchange Deutschemark Futures
8	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange S&P 500 Futures	NY Commodity Exchange Gold 100 oz.	Chicago Mercantile Exchange Deutschemark Futures	Chicago Board of Trade CORN FUTURES
9	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Silver 5000 oz.
10	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Gold 100 oz.	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Mercantile Exchange Swiss Franc Futures

* January - June, 1989

TABLE 4

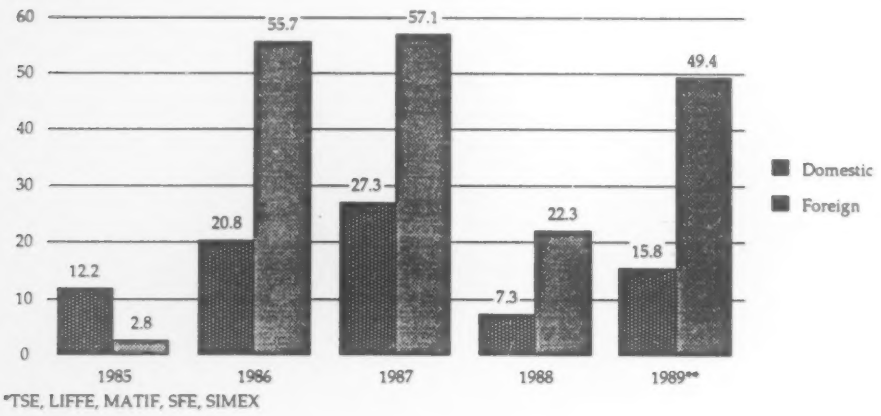
Number of Foreign Futures and Options Contracts
Traded in the Top 25 by Volume in the World; 1984-1989*

<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989*</u>
0	0	1	3	4	6

* January - June, 1989

FIGURE 2

Annual Growth Rates; 1985-1989
U.S. Futures Industry vs. Principal Foreign Futures Exchanges*
(percent)



**January - June

TABLE 5

Volume Growth of Financial Futures and Options
Contracts Trading on Foreign Futures Exchanges

1985-1989*

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989*</u>
<u>Government Bond</u> <u>Futures and Options</u>					
Average Daily Volume	13,686	77,980	171,723	189,751	217,733
Growth Rate (%)	--	469.8	120.2	10.5	14.7
<u>Stock Index Futures</u> <u>and Options</u>					
Average Daily Volume	1,590	6,655	59,914	47,428	91,153
Growth Rate (%)	--	318.6	800.3	- 20.8	92.2

* January - June, 1989

TABLE 6

FOREIGN COMPETITION

Treasury Bond Futures Volume; Chicago Board of Trade
and London International Financial Futures Exchange
October 1, 1987 to October 30, 1987

<u>Date</u>	<u>Chicago Board of Trade</u>			<u>LIFFE</u>
	<u>Night Session</u>	<u>Day Session</u>	<u>Total</u>	<u>Total</u>
10/01/87	23,466	261,753	285,219	5,970
10/02/87	9,047	368,448	377,495	995
10/05/87	10,963	267,009	277,972	4,336
10/06/87	7,623	244,259	251,882	7,890
10/07/87	10,522	362,278	372,800	8,525
10/08/87	10,626	442,189	452,815	6,891
10/09/87	15,363	308,742	324,105	7,775
10/12/87*	10,370	84,586	94,956	3,391
10/13/87	14,887	278,275	293,162	6,317
10/14/87	12,100	511,021	523,121	14,482
10/15/87	19,270	640,217	659,487	12,538
10/16/87	21,967	365,532	387,499	2,461
10/19/87	28,892	483,949	512,841	13,503
10/20/87**	28,269	34,487	62,756	47,082
10/21/87	44,552	311,180	355,732	15,955
10/22/87	13,933	366,911	380,844	12,465
10/23/87	28,266	323,253	351,519	16,079
10/26/87	19,203	272,409	291,612	12,529
10/27/87	20,937	280,655	301,592	13,398
10/28/87	15,270	337,029	352,299	10,900
10/29/87	15,542	224,911	240,453	9,537
10/30/87	17,400	220,040	237,440	7,352
Average Daily (Year-To-Date)	12,385	286,505	297,121	6,186

* Columbus Day; Banks and some financial institutions closed.

** Day session locked limit up

APPENDIX 2

The following appendix contains two Chicago Board of Trade reports*/ analyzing broker trading that were transmitted to the Commodity Futures Trading Commission (CFTC). In addition, this appendix includes the testimony of Dr. Sanford Grossman before the House Agriculture Committee. (As transcribed from a tape recording).

*/ The first report, entitled Study of the Rule of Broker Trading at the Chicago Board of Trade, MidAmerica Commodity Exchange and Chicago Rice and Cotton Exchange, was submitted to the CFTC on May 1, 1989. The second report, submitted to

Study of the Role of Broker Trading at the
Chicago Board of Trade, MidAmerica Commodity Exchange
and Chicago Rice and Cotton Exchange

Prepared by Staff of the Three
Exchanges in Response to a CFTC
Request of March 8, 1989

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I. Executive Summary/Conclusions

The practice of broker trading, or trading as a principal and as an agent, is widespread in the United States and abroad. At the request of the Commodity Futures Trading Commission, staff of the Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange have prepared the following study which describes and analyzes broker trading as it is practiced on the floors of the three futures exchanges.

This should be viewed as a preliminary study, as thorough study of the contribution of broker trading at the Exchanges would require more time than was allotted by the CFTC. As part of its further analysis, the CBOT has commissioned Professor Sanford J. Grossman of Princeton University to conduct a study of the role of broker trading in the futures and broader financial markets.

This study demonstrates that there are two principal benefits which broker trading brings to the futures markets. First, because broker traders are permitted to trade for their own accounts, they are able to engage in trading strategies in the course of executing a customer order which result in a better price for the customer than can be obtained by a broker who does not trade for himself. The study provides detailed examples of these trading strategies, describes the specific advantages customers derive from broker trading and presents letters from customers explaining why they prefer to have their orders executed by broker traders.

The second benefit of broker trading is that it adds substantial liquidity or depth to the market. The study shows that between 25% and 80% of the risk capital available in the markets examined is provided by broker traders.^{1/} Since broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets, and more capital, and this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity is provided by broker traders (for the benefit of all market users), presents further statistics describing the extent of broker trading activity at the three Exchanges, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

^{1/} The study points out the flaws with the definition the CFTC asks the Exchanges to use for purposes of the data analysis.

The analysis discusses the special contribution which broker trading makes in the markets at the three Exchanges. Extensive spreading activity has characterized the contracts at these Exchanges, which together with broker trading has been a key part of these particular markets and has helped them become the most efficient in the world. The price relationships among the delivery months in the grains contracts, for example, are the basis for hedging long term storage costs, an application of spreading which is an integral part of the U.S. agricultural industry. Likewise, the cost of carrying government securities can be hedged through spreading in contracts such as Treasury Bond futures at the Exchanges. The role of broker traders in facilitating inter- and intra-market spreading, thus distributing liquidity across commodities and delivery months and forcing bid/ask spreads (customer costs) as low as possible, is particularly critical in these markets.

In addressing concerns that potential trading abuses may be associated with broker trading, the analysis carefully differentiates between the practice of broker trading and potential trading abuses which may use that practice as a vehicle. The practice of check writing is occasionally abused by some who draft fraudulent checks. Restriction or prohibition of check writing would not address the abuses. Ensuring that a sound means of detecting abuses is in place and that a stringent set of sanctions has been defined and is applied as appropriate is a more direct and logical approach to dealing with trading abuses than the restrictions or prohibitions of broker trading which some have proposed. Importantly, this approach would not damage market performance as a broker trading curb would.

The analysis discusses the Exchanges' CTR Plus system which enables staff to easily pinpoint any instances of abuse, explains enhancements which have been made recently and which are planned in this system, and describes penalties which are applied if trading abuse is detected. This self-regulatory system which combines ease of detection with strict penalties provides an effective deterrent of potential abuses which may be associated with broker trading at the Exchanges.

II. Introduction

Scope of the Study

An analysis of the nature and effects of broker trading^{2/} is presented in this study. The study has been conducted in response to a request by the Commodity Futures Trading Commission (CFTC) that exchanges undertake an analysis of "dual trading"^{2/} and its contribution to futures market

^{2/} "Broker trading" is a more descriptive term than "dual trading" and will be used throughout this study.

-3-

performance. This study responds to the request sent to the Chicago Board of Trade (CBOT), the MidAmerica Commodity Exchange (MACE) and the Chicago Rice and Cotton Exchange (CRCE), three affiliated exchanges ["the Exchanges"].

In its letter to the Exchanges of March 8, the CFTC stated its request as follows:

"Continuing increases in volume in the futures markets could indicate that exchanges may consider dual trading less useful for liquidity than formerly believed to be the case. Further, it has been suggested from time to time that limiting dual trading could inhibit certain trading abuses and decrease potential conflicts of interest. Therefore, the Division requests that the exchanges collect and analyze current data relative to dual trading in their markets to assist in such an evaluation of dual trading. In this connection, each exchange should submit dual trading data covering a representative period of no less than one week in late 1988 for its most active, a moderately active, and a less active contract. For this purpose, a dual trader should be identified as anyone who executes a customer type indicator ("CTI") 1 trade and a CTI 2, 3, or 4 trade during a single trading session. These data should include, but not be limited to, the following:

- the number and percent of dual traders and non-dual traders,
- the following information stated separately for the open, close, least active 1/2 hour bracket, and most active 1/2 hour bracket: the volume and number of transactions by dual traders and non-dual traders for each expiration for each contract chosen, separately identified as CTI 1, 2, 3 and 4 trades.

The Division requests that your exchange provide a detailed analysis based on the foregoing data, and such other data as the exchange may deem relevant, together with an explanation of its methodology, as to the current need for dual trading in its markets. Your analysis should address whether or not potential limitations on dual trading could address the types of customer trading abuses actually encountered in exchange compliance programs. To the extent that you believe that restrictions on dual trading might unduly limit liquidity for particular markets, you should consider whether there are other mechanisms, such as the use of marketmakers, sunshine trading, or large or small order trade execution procedures which might serve the liquidity functions which historically have been attributed to dual trading."

This study presents only preliminary findings of the Exchanges' staff. Due to the volume of data under analysis and the complexity of the relationships between broker trading and futures markets, more extensive analysis needs to be done. This is not possible within the time constraints of the current April 30 deadline. Although the analysis which follows concentrates on futures markets, the Exchanges believe that the results of this study are applicable to the options on futures markets as well. The basic trading mechanisms in options and futures markets are identical and the role of broker traders is the same in both. The limitation of the analysis to futures reflects the time constraints.

As part of a more thorough analysis of broker trading, the Exchanges have commissioned Professor Sanford J. Grossman of Princeton University to study the role of broker trading in the futures markets and in financial markets generally. This study will be provided to the CFTC at a later date.

The Exchanges have serious concern with the CFTC's request which should be noted at the outset of this study. As will be shown in the analysis which follows, many traders will be termed "dual traders" (i.e., "broker traders") under the CFTC's definition^{1/} not because they actively seek to trade for their own account as well as for their customers during a trading session, but rather because trades made in the course of executing customers' orders must be placed in the traders' "error accounts" (a type of proprietary account) if the trades are not specifically requested by the customers or are not in conformity with the customers' orders. The study will demonstrate that such proprietary trades result from certain strategies employed by the broker trader as he works to obtain the best price for the customer. However, the data requested by the CFTC will show, for example, that a given trader who has used these strategies will be shown to have executed proprietary as well as brokerage trades during a certain time period -- and, hence, will be a "broker trader" -- when, in fact, the trader was strictly trying to execute trades for his customers' benefit. Thus, the data can be misleading and must be interpreted with caution. A number of different definitions of broker trading are possible, which may well provide different data and different policy conclusions.

Organization of the Study

The next section examines the nature of broker trading, notes its pervasiveness in all financial markets and discusses the definition used in this analysis. Section III also discusses

^{1/} i.e., "anyone who executes a customer type indicator ("CTI") 1 trade and a CTI 2, 3, or 4 trade during a single trading session".

the economics of broker trading and the reasons a broker trader chooses to engage in the practice. (Appendix A presents examples of trading techniques that are employed by broker traders.)

Section IV examines the benefits of broker trading for the market as a whole, focussing specifically on the relationship between broker trading and market liquidity as measured by the bid/ask spread and market depth. (An empirical analysis of the current activity of broker traders, using the CFTC definition, is presented in Appendix B). The specific benefits derived by broker traders' customers are also examined. (Appendix C contains letters from customers of broker traders supporting the practice). Finally, it is demonstrated that broker trading serves the needs of the highly variable demand for brokerage services by ensuring that a ready supply of brokerage and liquidity services is always most readily available.

Section V examines potential abuses which may be associated with the practice of broker trading. It examines the nature of such potential abuses and, noting that they are not extensively found, discusses the safeguards currently in place. Finally, the section evaluates proposals intended to address concerns with abuses associated with broker trading, with respect to their effectiveness in limiting potential abuses and their effect on the functioning of the markets.

Finally, Section VI presents conclusions regarding the role of broker trading in futures markets.

(Appendix D discusses the role of broker trading and other types of trading mechanisms, with respect to the provision of liquidity services.)

III. Nature of Broker Trading

Definition

In the broadest sense, broker trading is practiced by any individual or firm that functions in a fiduciary relationship for a client as an agent or advisor and trades as principal for its own benefit as well. The futures market floor broker who also trades for his own account is but one example of a broker trader. Other examples of broker traders are individuals or firms that have knowledge of a potential trade execution or process the execution order, but may or may not perform the actual execution. In many financial markets in the United States and abroad, individuals and firms who act as both principal and agent are integral parts of the route followed by a customer order on its way to execution. The individual who initially takes the order, the firm he works for and the individual who ultimately executes the order may all be broker traders. In the case of futures trading in the United States, the phone broker who receives a customer's

order may also be trading for his own account. The Futures Commission Merchant (FCM) that handles the order may be trading for its own proprietary account. The Registered Commodity Representative (RCR) may be trading for his own proprietary account. Thus, the trader on the floor of the futures exchange who ultimately executes the order may be one of several broker traders involved in handling a customer order.

While the example of an FCM is cited above, any provider of financial market brokerage services (e.g., a bank, a savings and loan, a credit union) could be a "broker trader". In financial markets, a brokerage concern that accepts futures or securities market brokerage and has proprietary accounts for trading in the same or an economically similar market (e.g., brokerage in stocks; proprietary trading in stock options) may correctly be labelled a "broker trader". Specialists are broker traders legally sanctioned by the stock exchanges to trade both for themselves and for others on the exchange floor. (It should be noted, too, that because the number of specialists is limited, there may be no alternative for those dissatisfied with their services.) Broker-dealers in the securities markets by definition are broker traders and are registered as such with their government regulator. In fact, although the securities industry has certain regulations regarding broker trading (i.e., trading as agent and principal), the recent history of indictments in the securities industry suggests that the so-called "Chinese Walls" set up by the industry to allow principal and agent transactions by the same economic entity may constitute more a porous screen than a real barrier.

Furthermore, it should be emphasized that broker trading is not strictly a U.S. practice. The practice is a principal mechanism for providing liquidity and executing customer orders in virtually every financial market of the world. For example, regulations in the United Kingdom were recently changed to permit single entities to engage in both proprietary and brokerage trading in the securities markets where such dual capacity trading had been prohibited previously. Broker trading is permitted and is prevalent on the floors of the London International Financial Futures Exchange (LIFFE) and the Marche a Terme des Instruments Financiers (MATIF), the two largest futures exchanges in Europe.

Despite the widespread practice of broker trading in the U.S. and foreign financial markets, we shall narrow the scope of the analysis and examine broker trading only from the perspective of the broker in the futures pit; specifically, the floor broker who may also trade for his own account.

Even from this perspective, the definition may vary, the previously expressed concern with the CFTC's definition notwithstanding. Is the broker trader a floor broker who

could trade as a principal but does not? One who does trade as a principal? Does he trade both as principal and agent within the same time bracket? In the trading session? Over the last week? Does he trade in the same contract month as the brokered customer? A spread involving that same contract month? A back month? Another crop year? Different, but related, commodities? The choice of definition and scope of definition could clearly lead to different empirical results and conclusions concerning the role of broker trading, and may have different policy implications.

For the purposes of this study, we will concentrate solely on the ability of a broker to act as both agent and principal in the same pit. (In the empirical analysis in Appendix B, however, we use the CFTC's definition of a broker trader as one who acts as agent and principal in the same trading session.) Therefore, in the following discussion, actual observance of both types of transactions is not a concern and a temporal dimension can be ignored. Furthermore, to set aside discussion regarding the material nature of spot versus back month contract information, we will view the broker trader as one trading in both capacities in any contract month in a given pit. Of course, more complete study of broker trading would necessarily have to explore more fully the scope of the practice under its various possible definitions.

The Broker Trader as a Businessman

It is useful to consider a trader in a futures pit as a businessman. An individual undertakes trades as both agent and principal because it is a prudent business decision. In the simplest case, a broker trader may be an individual businessman who is primarily a broker, but who needs the flexibility to execute a proprietary trade either as part of his brokerage activities (see Appendix A) or, lacking brokerage demand, to take advantage of a business opportunity. Conversely, the broker trader may primarily trade for his own account, but at times may be asked to provide brokerage for other individuals. In the active grain markets of 1988, for example, the demand for brokerage services was so high that some traders who normally did not execute customer orders, were asked to do so and many existing broker traders found they had no time to even consider trading for their own accounts. In slower periods, they provide brokerage as needed but also have greater flexibility to pursue profitable trading opportunities for their own account.

The trading business has high fixed costs due to seat prices, dues and time spent on the floor. As a profit maximizing businessman, the trader will seek to increase product lines as long as variable costs of doing so are less than the price he can receive for the product. An increase in product lines, and presumably sales, increases overall profitability

as fixed costs are spread over a greater number of sales. For example, the trader can take on brokerage activity with no additional fixed costs. Therefore, by taking on brokerage duties in addition to providing liquidity services to others in the marketplace, the trader can increase the overall profitability of the business.

As a business man, the broker trader has several goals. He hopes to have a profitable business. He knows he increases the likelihood that his business will be profitable and will endure if he provides the kind of services customers need. He wants to develop long term business relationships with these customers to ensure the continued success of his business. Thus he must focus his energies on helping the customers meet their own goals -- order execution at the best possible prices and at the desired time. If he does not help the customers meet their goals or if another broker trader does a better job of it, he will lose his business. The continued existence and viability of broker trading as a business is clear testimony of the success of broker traders in meeting the needs of their customers.

Customers are attracted to a broker trader precisely because he actively trades for his own account. His sense of the market and understanding of trading techniques which have been well-honed through his proprietary trading combine to enhance the quality of his brokerage product by enabling him to provide better order "fills" for his customers. (A discussion of broker trading strategies is presented in Appendix A.) In this role the broker may establish a spread by executing its two sides separately (i.e., by "legging") rather than merely accepting a spread available in the market; challenge what he feels is a wide bid/ask spread by bidding or offering a price different from that prevailing in the market; or disguise his customer's interest by raising questions in the minds of other traders as to whether the trade is being executed for a customer or for himself. Such activities are undertaken to improve the quality of the broker trader's brokerage services; i.e., to help customers meet their goals. This attracts more and repeated brokerage business and increases income for the broker trader only insofar as customers benefit from increased quality of "fills" or decreased cost of order execution.

Broker traders, like brokers who are not normally willing to risk making a proprietary trade in the course of filling a customer order, absorb the cost of their own mistakes in order-filling. These mistakes are placed in their proprietary (or "error") account.^{4/} However, in addition to losses related to mistakes in filling customer orders, broker traders may pursue trading strategies which force them to

^{4/} The problems which this may cause in interpreting the data requested by the CFTC has been noted previously.

incur temporary trading losses in the course of getting the best execution for the customer. For example, consider a broker trader who has a large customer buy order to execute. After the broker trader executes a certain portion of the order, he finds that the offer price has risen, perhaps because opposing traders sense that there is a substantial quantity remaining to be bought by the broker trader, or for a variety of other reasons related to market conditions. Seeing this, the broker trader sells a quantity for his own account in an attempt to disguise his intentions to buy more contracts for his customer. This proprietary transaction might even reduce the prevailing market price for his customer's benefit. The offer price may fall and permit the broker trader to complete the buying for his customer at an advantageous price. If the price ~~does~~ drop, of course, the broker trader makes a profit on his proprietary position. If, however, the offer price ~~rises~~, the broker trader may decide that the remainder of the order should be filled at the higher price (before it rises even more), which he deems would be in the best interest of the customer. In this case, of course, he loses money on his proprietary position, taken initially in an attempt to get his customer the best fill. (Further illustration of such strategies is given in Appendix A.) The above example illustrates the judgement which the broker trader must exercise in executing a customer order. The quality of this judgement sets the broker trader apart from other brokers in his ability to provide brokerage service. Customers seek to obtain the broker trader's good judgement -- and are willing to pay for it -- knowing that it has been developed and refined through his trading for his own account and knowing that they can continue to compare this service against the services of other competing broker traders.

Some question why a broker trader would make a potentially losing trade to benefit a customer. Such a view concentrates on merely a portion of the broker's business and for only a short time period. The broker trader's rationale for establishing a potentially losing proprietary position makes more sense if one views the broker trader's activities in the market as a whole and considers long term relationships with brokerage customers; i.e., considers the broker trader as a businessman. If a losing trade borne on occasion by the broker trader leads to better fills for customers which in turn lead to more customer trades, the cost of the broker trader's loss should be offset in the longer run by the increase in overall trading. Some losing personal trades may therefore be viewed as a business expense by a broker trader desiring a large customer base. Broker trading, therefore, makes economic sense if used effectively for the enhancement of the brokerage services the trader provides.

As noted in Section V, severe penalties and high likelihood of detection explain why few violations of exchange rules occur through broker trading. However, some futures market

customers may still prefer that their brokers specialize in brokerage. These customers may feel that brokers who do not trade for themselves provide better service or that they can avoid any potential abuses associated with broker trading. Customers having this view are not compelled to use broker traders. Customers have a choice to receive brokerage services from a broker trader or from a broker who does not trade for himself. The data suggests that this choice is exercised. For example, in the CBOT U.S. Treasury Bond futures pit on October 5, 1988, 81% of brokered trades (CTI 2, 3 or 4) were executed by broker traders for that day and 19% were executed by brokers who did not trade for their own account that day. In the CBOT Wheat futures pit on that day, the percentages were 89% and 11%, respectively. The data indicate a strong customer preference for brokerage services offered by broker traders.^{5/}

To summarize, the businessman/broker trader chooses to trade for himself as well as his customer to increase the amount of services he supplies to the market (in hopes of increasing his income) and to provide his customers better service (in hopes of attracting even more brokerage business). Customers who do not receive the quality of brokerage service they need, will take their business elsewhere.

IV. The Futures Markets at the CBOT, MACE and CRCE and The Effects of Broker Trading Activity on These Markets

The Nature of the Markets at the three Exchanges

The provision of good spreading services is particularly important at the three Exchanges. Many of the contracts at the Exchanges are used for spreading to lock in cost of carrying physical commodities, such as grains. The price relationships among the specified delivery months create opportunities for hedgers in the grain markets to tailor the type of protection they obtain through their use of the futures markets to the period of time they will maintain their inventories. Use of these intermonth price relationships in the futures contracts for hedging is an essential part of the grain business.

Inventory issues are also a concern to those in the business of trading financial instruments such as U.S. Treasury Bonds. Many customers routinely using futures spreads to complement their storage or inventory operations direct their orders to broker traders who can execute spreads most effectively. The futures contracts which trade at the three Exchanges are widely used in conjunction with inventory management and thus the high quality spreading services which broker traders can provide are in particular demand.

^{5/} The CFTC definition of "broker trader" underlies these data. Problems with the definition have been noted earlier.

Furthermore, use of many of the contracts offered at the Exchanges entails routine rollovers (shifting a position from the nearby to a deferred month) at the expiration of contract delivery months. For the rollovers to be carried out efficiently, adequate liquidity is necessary in the deferred months. Spreading activity between deferred and nearby months is a principal source of liquidity in the deferred months. Broker trading is essential in all delivery months and perhaps particularly critical in the nearby months which provide the liquidity that the broker trader distributes, through his spreading, to the less liquid deferred months. Most of a broker trader's spreading activity includes a position in the liquid nearby month. He would be less willing to risk placing a position in an illiquid deferred month -- a position which might eventually be entered into his proprietary account if it does not fill the customers needs -- and thus would not provide deferred month liquidity, if he were unable to establish a corresponding position in the nearby month.

Broker traders are thus essential in servicing the needs of customers in the kinds of markets which trade at the three Exchanges. Their importance in not only providing quality fills for customer spread orders, but also in ensuring proper conditions for rollovers cannot be overstated.

The Benefits of Broker Trading

In general, broker trading provides benefits for futures market participants in three ways. First, broker trading enhances futures market performance by increasing market liquidity, yielding tighter bid/ask spreads and increased market depth. This is particularly important in less liquid pits and in deferred contract months and results in lower costs of order execution for the customer. Second, customers of broker traders benefit through better execution prices that are available through unique trading techniques and the increased trading flexibility that the ability to broker trade gives a broker. Finally, broker trading benefits all potential futures market brokerage customers by maintaining a residual supply of brokerage services to meet a volatile changing demand. This is especially important in markets such as those at the three Exchanges whose risk (and demand for hedging brokerage services) varies widely from month to month, season to season, commodity to commodity. The active grain markets at the Exchanges in the summer of 1988 illustrated the importance of having a reserve supply of brokerage services which was demanded by customers on short notice as price volatilities and trading volume shifted sharply from hour to hour, day to day and week to week. Broker traders can respond to the brokerage demand whenever and wherever it occurs. Each of these benefits is discussed below.

Broker Trading and Liquidity

Liquidity of a market is its capacity to facilitate trade executions. A liquid market will enable market participants to execute orders of a certain size more easily and quickly than an illiquid market. The bid/ask spread, the difference between the cost of buying a commodity in the market and the cost of selling it at any point in time, is one widely used measure of liquidity. The spread reflects the ability to offset an earlier transaction (i.e., sell if one has purchased previously; buy if one has sold previously), thereby minimizing risk and cost of trading in the market.

The existence of broker traders in a pit adds more buying and selling capacity over a range of market conditions and makes more risk capital available to service hedging and investment needs of market participants. The institution of broker trading brings more capital to a pit and more traders to provide trading services. Market liquidity is enhanced as risk capital in the pit increases and trading costs are reduced. Risk capital is increased since brokers can establish speculative positions for their own account by broker trading. There is also an increase in risk capital in a pit due to increased trading opportunities. A trader able to do both brokerage and also trade for his own account, is more apt to find a satisfactory number of trading opportunities in a low volume pit than a trader who is more limited in his trading practices. The broker trader may find that a low volume pit provides adequate incentive to attract him to offer his trading services (brokerage and market making) in that pit. The increased risk capital which the broker trader brings to the pit lowers the bid/ask spread by providing additional opportunities for all market participants to offset a trade and by creating competition among market makers for a trade on the floor. The process feeds on itself as increased risk capital leads to greater liquidity, and since greater liquidity reduces the risk of committing capital to the market (it is easier to offset a losing trade), more risk capital is attracted. In the absence of broker trading, risk capital in the pit would be decreased, and trading costs would increase, to the detriment of all customers.

Broker traders in a pit can provide liquidity or market making services when brokerage demand is slack. For example, if a pit has 10 broker traders and 10 local traders, or market makers, the effective number of market makers available in the pit becomes 20. The additional market making capacity is always available (if brokerage demand is slack) with the presence of the broker traders. Moreover, this additional market making capacity is provided by experienced traders whose services can be made quickly available.

As requested by the CFTC, the Exchanges have compiled and analyzed data describing the extent of broker trading activity in the markets. The CFTC's definition has been used in the analysis despite the problems noted at the outset of the study which can cause confusion in interpreting the data. The analysis, which is necessary preliminary in light of the short deadline, is presented in Appendix B. The data itself is provided separately to the CFTC.

Customer Benefits From the Existence of Broker Trading

As noted in the numerous letters received from customers who approve of the practice of broker trading (see Appendix C), customers benefit from and continue to choose to use brokers who also trade for themselves. Customers recognize that there are several reasons their broker can give them better order fills because he is a broker trader. (Appendix A provides examples which illustrate these benefits.) First, customers know that because the broker trader also trades for himself, he has greater incentive to learn the subtleties of the market and therefore how to best execute an order.

Second, the broker trader can execute a customer order without signalling his intentions to the pit in a way that could adversely affect the price paid or received by the customer. Opposing traders do not know if he is trading for the customer or for himself. The ability of the broker trader to disguise his trading intentions is particularly important to his large customers whose large sized orders could otherwise receive a worse price. Furthermore, the confidentiality of the customer order can be preserved. This is particularly important to a customer who is a major factor in the cash market and whose business would be adversely affected if his competition (also futures market participants) knew his intentions (e.g., a large multinational grain firm with a pending export agreement).

Third, the broker trader can use his own account to help execute customer orders by "legging" spreads. Customers who want to initiate a spread position (the simultaneous purchase of one contract and sale of another in the expectation of a profitable change in the price relationship between the two contracts) require that two positions be established, a buy and a sell. It is often possible for the broker trader to obtain a spread (i.e., with both the buy and sell "legs") from another trader. Alternatively, the broker trader can execute the buy and sell transactions separately, thus constructing the required spread. This is called "legging the spread". A skillful broker trader is often able to "leg" the spread for the customer at a price which is cheaper than the cost of the spread available from another trader (see Appendix A). The customer benefits by receiving the spread he sought, and the broker trader benefits by satisfying the customer and probably keeping his business. Customers who monitor the price movements in the market and know what

prices have been available in the pit will recognize that the broker trader went out of his way to fill the order. The businessman/broker trader will likely retain their business.

If broker trading were prohibited, many of the current broker traders would trade only for themselves and cease providing brokerage services. They would leave the brokerage business because they would not be able to draw on their trading skill to provide particularly high quality brokerage service to their customers. Thus, as compared to brokers who do not trade for themselves, they could offer no special incentives to potential customers to attract their business. Furthermore, under a broker trader prohibition, brokers would not be willing or able to employ the techniques used by broker traders because they could not risk a proprietary trade (see Appendix A). Broker traders would lose a trading advantage, or "edge", vis-a-vis local traders. The trading disadvantage which broker traders would then have relative to locals in the pit would cause broker traders to become locals trading only for themselves. With fewer broker traders to compete in the business of offering brokerage services, customer commissions and bid/ask spreads to customers would be expected to rise. Furthermore, as the best broker traders would trade solely for themselves, traders of lesser ability would act as brokers. Customers would be left with few brokers, less competition and only those relatively less talented brokers to fill their orders.

Because broker traders can trade for their own accounts, they have the obvious incentive provided by the profit motive to learn the subtle details of how the market behaves. Customers who execute orders through someone who also trades for himself know that they are dealing with a market expert. They benefit from the traders' ability to read market trends and provide them the best possible price and market information. Customers who do not like the quality of the execution they receive can change brokers. Customers monitor the quality of order fills and change brokers when warranted. A large number of qualified brokers are available on the floor of the Exchanges for customers to choose from. If a customer prefers to channel his orders through a broker who does not trade for himself, he may choose to do so. The continued existence of a large number of broker traders is proof of their value to customers. If there were an inherent bias against customers in the broker trading practice, customers would abandon broker traders in favor of brokers who do not trade for themselves and broker traders would cease to exist. Indeed, as noted earlier, there appears to be a customer bias in favor of broker traders in the pits at the Exchanges. (See the letters from the customers of broker traders, Appendix C.)

To ensure that they have the best broker for their needs and to compare the services provided by the available brokers, customers often "shop around" by, for example, asking several

brokers to execute an identical spread. The broker providing the best service -- whether or not he is a broker trader -- ultimately gets the business over the long term.

As noted previously, another reason customers receive better prices when a broker trader executes their trades is that the trader is able to avoid revealing his (i.e., his customer's) intentions to buy or sell. This benefit is especially critical when a customer submits a large buy or sell order, or when a customer fill is needed without delay (e.g., at the open or close, or in volatile, fast moving markets) and the broker trader cannot wait for what he views as a temporary price disadvantage to correct itself. A broker trader can, and often will, protect his valued customer by, for example, disguising his customer's buy order by making a sale from his own account prior to executing the customer's buy order. This action may help prevent prices from rapidly rising before or during the execution of the order (large orders often cannot be executed entirely in one transaction and, instead, are executed in parts) and thereby helps the customer obtain a better price. In another situation, the broker trader may have a large customer buy order to fill but considers the prevailing offer price to be too high. In this case, the broker trader can sell a certain quantity for his own account in an effort to see if the prevailing offer price will move to a level he considers to be more attractive, given market conditions at that particular time. If the offer price does fall, he fills the customer order at the better price. These are examples of the kind of market judgement at which the broker trader excels and for which customers are eager to pay. (See Appendix A for further examples of how the broker trader exercises his judgement to benefit the customer.)

Although it might seem surprising that a broker trader would sell from his own account while holding an order that may indicate information that will signal higher prices, skilled broker traders do this in order to assure that customers get good fills. By keeping his customers satisfied, the broker trader/businessman assures himself a stable source of commission income, and that income is worth taking some risks in his own account. Competition from other broker traders in the pit may force him to take these risks. Moreover, the skilled broker trader may be required to bear these risks only temporarily since he may be able to offset them through other trades once the customer order is executed, for example, using spreads involving the liquid nearby month.

The additional liquidity generated by the presence of broker traders means that customers receive higher prices when they sell and lower prices when they buy. Large orders affect prices less in liquid markets. Furthermore, by allowing traders to also provide brokerage services, the practice of broker trading increases competition for brokerage customers and thereby helps keep execution costs low. In his 1981

paper, Stanley^{6/} works through several scenarios which demonstrate that brokerage costs would increase if broker trading were prohibited. Stanley's analysis demonstrates that, depending on the assumed cost of an exchange seat and the number of contracts that can be traded by a single trader each day, a ban on broker trading would result in some combination of increased total brokerage fees charged to customers and slower execution of customer orders. From his simulations, he concludes "...the dual trading commissions would always be less than the commissions without dual trading".

Provisions of Reserve Brokerage Capacity to Meet Future Needs

An additional benefit of broker trading is that it creates a pool of experienced trading expertise that can be drawn upon to meet periodic increases in the demand for brokerage services. The demand for brokerage services is directly related to price volatility. In a flat market, less brokerage demand exists. However, in a highly volatile price environment the demand for brokerage services will be very high. This can be observed on an intra- or inter-day basis. For example in the summer of 1988, drought conditions produced substantial increases in agricultural price volatility. This market environment increased the demand for risk management instruments and, therefore, for the execution services of floor brokers. Since most traders who regularly did brokerage were already swamped with the demand for their services, brokerage demands were placed on traders who normally traded strictly for their own account. Having the freedom to broker trade, these traditional locals were able to meet this increased demand. In the absence of broker trading, with shortages of brokerage services, brokerage fees would have had to rise sufficiently to offset the cost of brokerage start-up in order to elicit new brokerage supply. Floor brokerage fees were raised 20¢ per trade by many FCMs during the busy markets (The fees have since been reduced again to previous levels). The fees could have been raised much higher if reserve brokerage services had not been available from broker traders. Without broker traders, adequate brokerage services might very well not have been available at any cost in an hour, a day or a week if new brokers had to be trained from scratch. Since the practice of broker trading was possible, those start-up costs were minimal for locals already in the pit or in nearby pits. Without broker trading, risk management customers would not only have faced increased bid/ask spreads because of increased uncertainty in the volatile market environment, but higher brokerage fees and higher execution costs as the increased brokerage demand would have more likely been met

6/ Kenneth L. Stanley, "Measuring the Operational Costs of Dual Trading: An Analytical Framework," The Journal of Futures Markets, Vol. 1, No. 3, Fall 1981, pp. 329-336.

with inexperienced or minimally experienced traders. Some customers would have had to wait for new brokers to be found. It might not have been possible to immediately meet the demand, even with inexperienced brokers.

Full members of the CBOT, many of whom are broker traders, have certain trading rights at the Chicago Board Options Exchange (CBOE). Historically, when CBOE markets have been active relative to those of the CBOT, some of the CBOT full members have shifted the principal focus of their trading activities to the CBOE. This drain of brokerage services from the CBOT markets has occasionally caused shortages for customers when CBOT markets have suddenly become active. In such situations, the available brokerage services in CBOT markets have been reduced, and may not be immediately replenished by CBOT full members returning from the CBOE since they now have a commitment to trading there. Over time, if CBOT markets remain active, the full members may return and the total available brokerage services increase. However, the fact that this process takes time illustrates the difficulties a market can experience in immediately responding to increased brokerage demand by drawing on supply from another market. The reserve supply of brokerage services which broker traders provide to the market can be drawn on much more quickly.

Empirical analysis is needed to fully understand how the role of broker traders in the extremely active agricultural markets of summer 1988 compared with broker traders' role in earlier, less active periods. In particular, it would be necessary to study how the number of broker traders and brokers who did not trade for themselves differed in the two types of market conditions (e.g., in the corn and soybean markets at the CBOT in July 1988 vs. July 1987), and the trading volume and number of trades for which they were responsible. This is among the important topics relating to broker trading that deserves further attention.

From an economic perspective, flexibility for future decision making in an uncertain market environment has a value referred to as "option value". Option value usually has a cost associated with it. For example, a man may use his car to drive to work. However, he will be willing to pay for a public bus system to ensure that he has a method of getting to work if his car breaks down. The bus system has option value to him despite the fact that he may never use it. In the context of the futures market pits, broker trading has value to all potential futures customers. In times of increased brokerage demand, customers know they have a ready supply of brokers they can turn to. Broker trading provides flexibility and has option value. This option value presents no cost to these potential customers. Moreover, broker trading enhances market liquidity for the customers even when they do not need to call on the additional brokerage capacity it provides. It is an uncompensated positive contribution of

broker trading that benefits the market generally. The more variable the level of demand from brokerage services, the more vital this reserve brokerage capacity becomes. Study of the variability of brokerage demand would further illuminate the value of broker trading.

To summarize, broker trading presents three major benefits which are particularly critical at markets such as those available at the three Exchanges. First, it increases market liquidity, producing lower bid/ask spreads and increased market depth. Second, when performed by a skilled trader, broker trading benefits the customer by providing superior execution services on the floor. Third, broker trading provides reserve brokerage services which may be called upon by future market users.

V. Concern With Potential Abuses That May Be Associated With Broker Trading

It is necessary to distinguish between broker trading -- a market practice that provides significant benefits to participants of futures and other financial markets -- and abuses associated with this practice. The Exchanges have an extensive self regulatory structure which defines trading abuses, including those which may be associated with broker trading, and prescribes penalties for those committing these abuses. Abuses associated with broker trading are easy to detect and despite the fact that the Exchanges police the markets aggressively, few instances of abuses committed by broker traders have been uncovered. Moreover, few customer complaints have been received. Currently, the penalties specified by the Exchanges focus on an individual broker trader or other type of market participant committing an abuse. By contrast, the extreme measure of prohibiting broker trading would provide no guarantee that the abuses would disappear while guaranteeing the elimination of the benefits of broker trading from the market. Moreover, such an extreme measure implies that the practice of broker trading itself is an abuse which, of course, it is not. Thus, the discussion of abuses which may be associated with broker trading must be framed carefully. Elimination or restriction of broker trading is not a panacea for market abuses, even for those abuses which a broker trader potentially could commit, in violation of Exchange rules. This point is obviously understood by the International Stock Exchange in London that recently changed its rules to allow broker trading.

Nature of Potential Abuses

Some have asserted that the ability to broker trade places a trader in a position with an inherent conflict of interest. Some say this conflict provides an incentive to breach the fiduciary duty that is owed to a customer. Although it is important to note that such a breach would have a minimal

effect on the quality of futures market prices generally, it could adversely affect the quality of customers' fills. Two ways in which the quality of a given customer's fills could be reduced are:

1. Trading ahead of a customer's order.

- This is against the rules of the Exchanges. Of course, a customer is harmed only if the act of trading ahead adversely affects the price he receives. However, the act of trading ahead is illegal, no matter how or whether the customer is affected. Traders found trading ahead of their customers are punished severely. Exchange rules provide for fines up to \$75,000 per violation^{7/} and suspension or expulsion from the market. Expulsion from the Exchanges obviously constitutes a loss of livelihood and is thus an extremely severe penalty. The mere existence of this rule and its enforcement already discourages broker traders from executing proprietary trade close to the time of a customer order execution. The Computerized Trade Reconstruction (CTR) System (described below) can readily pinpoint an instance of a broker trader violating Exchanges' trading ahead rules.

2. Taking the other side of a customer's order.

- This is a form of "bucketing" that denies a customer a competitively determined market price on a fill. It is against the rules of the Exchanges. It is illegal no matter what the effect on the customer. As with trading ahead, the practice is easily detected using the CTR system. Instances of this abuse occur infrequently at the Exchange, but when they do, the severe penalties noted above may be levied.

Neither of these abuses is inherent in broker trading, nor are they implicit to the broker trading practice. While each of these abuses is potentially remunerative, the disincentives to engage in such practices are so high as to offset the incentive for abuse. The disincentives to engage in these abuses are two-fold: a high probability of the detection of such violations through use of the CTR system and potentially high exchange penalties for violations (\$75,000 fine,^{8/} possible expulsion). Furthermore, if a

^{7/} The Board of Directors recently recommended an increase in fining authority from \$75,000 to \$250,000 that can be levied in cases of trading abuses.

^{8/} A \$250,000 fine has been proposed.

broker trader is found to be engaging in such abuses, he will likely lose his customers and, thus, his brokerage business, even if he is not expelled from the Exchanges.

As noted above, Exchanges employ the Computerized Trade Reconstruction ("CTR") System, the most-sophisticated audit trail and surveillance tool in the financial markets. The CTR System reconstructs the daily trading activity by computing the execution time of each transaction executed on the Exchanges' trading floors. The CTR System gathers the executing broker, executing firm, order entry time, quantity, price, order or trading card number, opposite broker and firm, and half-hour time bracket for every trade. Each time a price change occurs in the market, the new price, along with the exact time it was executed, is electronically recorded in the Time and Sales Journal by independent Exchange employees. The CTR System takes the trade data submitted into the clearing system along with the Time and Sales Journal information to calculate the time each trade was made to the nearest minute or less ("CTR TIME"), typically to the nearest second. The CTR Time is an essential element in the Exchange's ability to reconstruct the day's trading activity in any futures contract.

The CTR audit trail data then forms the basis for CTR PLUS, the surveillance systems which analyze CTR trade data for possible violations of CBOT Rules and Regulations. CTR PLUS has the ability to identify every trade in the market and isolate where potential problems might exist. The system identifies who made what trade, at what price, and when. Most importantly it looks at whether the price was reasonable given prevailing market prices at the time.

This year, as part of their routine surveillance program, investigators on the Exchanges' staff have begun to review all daily trading activity, using information that is available the morning after the trading date. This is analogous to the Internal Revenue System examining every single tax return for errors, rather than a random sample. The investigators routinely look for broker traders who trade ahead of their customers' orders by having CTR PLUS automatically search for instances when brokers receive a better price for their personal accounts than for their customer orders. Investigators also look for trading patterns suggestive of taking the other side of customer orders.

As noted by the "Brady Report"^{2/} released after the 1987 stock market crash, the audit trail systems of the U.S.

^{2/} Report of the Presidential Task Force on Market Mechanisms, January 1988; p. 67.

futures markets are already superior to those available in the U.S. securities markets:

"The futures clearinghouse and large trader information systems currently allow assessment of trading time by trading customers. The stock exchanges have no system which details trades and trading times by customer. Stock systems include only the broker-dealers involved and whether the broker-dealer acted as principal or agent. Customer information for all market segments is critical to assessing threats to the intermarket system, and all major exchanges should be required to maintain such an information system. The October experience illustrates the need for information systems capable of monitoring conditions throughout the one-market system."

The CTR Plus surveillance systems are a keystone of self regulation at the Exchanges. An accurate CTR system is necessary to detect any trading abuses, including those that may be associated with broker trading. No surveillance system is perfect but the CTR is the best available. Improvements costing \$1 million have been planned which will enhance the system further.

To further increase the capabilities of the CTR and the CTR Plus systems in monitoring trading activity and pinpointing real or potential abuses, nine trade practice resolutions were unanimously approved by the Board of Directors, on March 2, 1989, for implementation no later than September 1, 1989:

1. Change the standard time bracket increment from 30 minutes to 15 minutes.
2. Establish a period of less than 5 minutes as the first time bracket for all contracts' respective trading sessions.
3. Establish a period of less than 5 minutes as the last time bracket for all contracts' respective trading sessions.
 - These tighter time bracket increments will permit increased precision in timing and confirming the timing of the trades of broker traders (and others). The change creates more and more accurate timing variables which can be used in the CTR Plus computer programs to pinpoint trading times.
4. Establish complete accountability by members and clearing firms for all sequentially-numbered trading cards on a daily basis.

- Broker traders (and others) will be held accountable for all of their pre-numbered trading cards and the accuracy of the sequencing information they contain.
- 5. Require that members' trading cards be picked up by clearing firms throughout the trading day at one-hour intervals from the opening of each respective market.
- 6. Require that clearing firms submit trades to the Board of Trade Clearing Corporation within one hour after the relevant trading cards have been collected from members.
 - The processing of trading data and the development of the audit trail relating to broker traders (and others) will be expedited. The change moves the information quickly and regularly from the traders to independent exchange and firm employees.
- 7. Require that all trading cards receive the Exchange-designated time stamp as they are taken from the Exchange floor.
 - This will provide another precisely-timed variable which can be used in pinpointing trading times of broker traders (and others).
- 8. Establish an Exchange floor "master clock" system, accurate to the nearest second, by which all time stamp machines on the floor would be synchronized automatically.
 - Any time discrepancies among time stamp machines which lead to errors in timing the orders and cards of broker traders (and others) will be eliminated.
- 9. Install an "automatic bell" on the floors of the Exchanges specifically to designate the time of each bracket change.
 - This change will facilitate the accurate recordation of time bracket information by broker traders (and others).

These changes are very much in the spirit of the ideas for improved futures market regulation proposed by Senator Patrick Leahy in his March 5, 1989 letter to the Exchanges. A principal proposal was for the CFTC to mandate improvements in exchange audit trails. These changes planned by the Exchanges represent the latest in a continuous series of enhancements in the Exchanges' market surveillance mechanisms. These enhancements will continue to improve the Exchanges' ability to detect abuses associated with broker trading and should also provide additional assurance to

market participants that any abuses related to the filling of customer orders will be uncovered.

Prohibition and Restrictions

The costs of any abuses associated with broker trading are borne directly by the broker trader's customers, not the market generally. The best individuals for assessing those costs are these customers. The Exchanges have received few customer complaints of abuses related to broker trading. However, if a customer feels that broker trading imposes a cost on him, that customer can receive execution services through a broker who does not trade for himself. Conversely, if a customer desires order execution through a broker trader (the letters in Appendix C show that many customers do prefer the brokerage services of broker traders), they can receive such execution. Thus, customers who are dissatisfied with the executions of broker traders are free to direct their business elsewhere. However, the continued existence of broker traders provides clear market evidence that the brokerage services they provide are much in demand.

If there are concerns with the possibility that broker traders may commit some improprieties, prohibitions and restrictions are the least efficient methods of controlling these improprieties. Prohibition or restriction of the practice of check writing to eliminate or reduce the use of fraudulent checks would be similarly misdirected. Prohibitions and restrictions do not eliminate abuses but merely preclude one vehicle for the abuse. The abuse may still continue through another vehicle. Banning checks would force those who abuse the check writing practice to consider, perhaps, misuse of credit cards. Banning broker trading would eliminate any type of abuse by broker traders and would merely force a dishonest trader who seeks to violate Exchange rules to use another vehicle for doing so. Prohibitions and restrictions of broker trading may be easy to decree, but clearly are simplistic and would impose severe costs on those using the markets directly, as well as those who benefit indirectly from the existence of futures markets and the presence of broker traders without solving any real problems. Moreover, the focus of these prohibitions is misplaced since it is on a practice, not on an abuse.

Proposals calling for prohibitions and restrictions of broker trading certainly do not appear to be justified on the basis of a cost/benefit analysis of the particular proposals. A detailed cost/benefit analysis should certainly be done on any specific proposal before it is given serious consideration. Furthermore, although more work needs to be done to fully describe the benefits of broker trading, no evidence currently exists that suggests the actual costs of abuses associated with broker trading abuses are large or that some form of broker trading prohibition would provide such a cost savings as to justify its adoption. A

prohibition of broker trading would not eliminate the potential for customer abuses. Such a prohibition may not even reduce the potential for abuses which are currently associated with broker trading if such abuses could also be committed with another trading vehicle.

As noted at the outset of this study, the practice of broker trading is widely used in the financial markets. If the total elimination of customer trading abuses is a social goal, the only solution is to close down all of our financial markets. The specialists trading on the stock exchanges, the broker dealers in the government securities market and all other broker traders would necessarily be included in any action. Of course, such a solution is not considered viable since all benefits of our financial system would be lost. The only reasonable approach to any problem of customer abuse involves enhancement of detection capability and imposition of appropriately large penalties for those found committing an abuse. Reducing the efficiency and raising the cost of doing business in the United States through ill-conceived prohibitions and restrictions of the beneficial practice of broker trading imposed selectively on one of the country's most important financial markets would certainly result in loss of markets to foreign competitors.

Ill-Conceived Proposals to Restrict Broker Trading

The following proposals to restrict broker trading have been put forth by various individuals concerned with the potential for abuses associated with broker trading. All are flawed, as explained below. The principal flaw, common to all these proposals, is that they focus on the practice of broker trading, which, itself, is not an abuse. Broker trading, like other practices in the financial markets such as investment banking, inter-market arbitrage, market making or options writing, can be conducted with or without abuses. A carefully constructed regulatory structure is necessary to define the abusive behavior, ensure that means of detection are adequate, and provide for penalties which will serve to deter wrong-doing. Such a regulatory structure exists currently and serves the interest of the customers better than any of the following proposed procedures.

1. Limit the size of customer orders which a broker trader is permitted to execute (e.g.; Order size must not exceed 100 contracts).

This proposal would restrict the incidence of any abuse associated with broker trading to small customers, thus creating inequitable treatment of different types of customers. Large customers would be forced to break up their large orders among many broker traders or would have to rely on brokers who do not trade for themselves. As noted earlier, these brokers do not have the same facility to obtain the best price as the broker traders

do. The incrementally lower quality fills for large orders could have a substantial adverse impact on large firms' operations. Since these large firms are very often active in world markets, aware of alternative trading opportunities abroad and positioned to take advantage of alternative international markets, significant business would be lost to foreign competition.

2. Limit a broker trader to a certain amount of brokerage activity during a session (e.g.: A broker trader is permitted to fill customer orders representing no more than 500 contracts in a session).

Again, the total volume affected by any abuses related to broker trading might be limited. However, the amount of brokerage services available in the pit would be severely limited, as well, and if market conditions resulted in a sharp increase in intraday demand for brokerage services, that demand could go unmet. In the long run, rising demand for brokerage services in a situation of limited supply would result in higher brokerage costs and/or the entry of possibly less skillful brokers who, at least in the short run, would provide lower quality fills. Customers would seek to obtain fills in other, less restricted markets.

3. Permit a trader to do brokerage at certain periods and proprietary trading at other periods. (i.e.: He would be prohibited from trading for customers and himself in the same trading period.)

Under this proposal, the trader would not be free to practice broker trading. Once he committed to doing either brokerage or proprietary trading, he would be restricted to that single type of trading activity. If customer demand for brokerage services were to rise during a day when few traders have declared their intent to do brokerage, capacity would be inadequate to meet customer needs.

4. Prohibit broker trading in the nearby month.

Some contend that the liquidity services of broker traders are not needed in the nearby month where trading activity is the greatest. Thus, the reasoning goes, a ban of broker trading in the nearby month would at least eliminate abuses associated with broker trading in the most active month. However, prohibiting broker trading in the nearby month effectively would prohibit it in all months. When broker traders "leg" spreads or execute "rollovers" for their customers, the process involves various combinations of positions in the nearby and deferred months which must be placed and lifted at times and under circumstances dictated by market conditions

(See Appendix A). Loss of the ability to trade flexibly in the nearby month which provides the fulcrum for many of these strategies would require the broker trader to accept less advantageous prices for his customer.

5. Prohibit broker trading in liquid contract markets.

This proposal is based on the view that the liquidity services which broker trading provides are not needed in active contracts; i.e.; that liquidity would be sufficient without broker trading. However this contention ignores the fact that deferred delivery months of even very active contracts are often illiquid. Broker traders, through their spreading and other trading techniques, augment liquidity in deferred months. Furthermore, customers demand the same high quality order execution, which broker traders provide, in liquid markets as they demand in less liquid markets. The provision of deferred month trading services depends importantly on broker trading in the liquid nearby months. Customer execution would suffer if broker traders were banned from active contract markets or delivery months.

6. Ban broker trading at the open and the close of trading, or in fast markets.

When markets are trading actively, broker traders often are so busy executing customer orders that proprietary trading is not possible. However, removing the broker trader's ability to employ his unique trading techniques for the customers benefit in rapidly moving markets would lead to less satisfactory customer fills during these periods (see Appendix A). Further, such a ban would preclude the broker traders who need to do brokerage business at the open or close from filling errors from the previous day which they took into their own accounts.

7. Ban broker trading completely.

All the liquidity and order execution benefits of broker trading would be lost to the futures markets. Customers would take their business to markets, perhaps overseas, which provide the liquidity and transaction services they require.

VI. Conclusions

The contribution of broker trading to market liquidity and to the effective execution of customer orders is substantial and not well understood by many of those suggesting that the practice be curbed. As the foregoing analysis has shown, outside customers of the futures markets -- the agricultural firms, the pension funds, the government securities dealers,

the banks and others -- who use the markets to manage their business risks or for investment purposes would be among those entities which would be hurt the most by a limitation or a ban on broker trading. It is ironic that these customers are the intended beneficiaries of a broker trading restriction.

Broker trading cannot be limited or prohibited without substantial adverse (and, perhaps unintended) consequences. Vitally, as noted in the analysis, there is no guarantee that the abuses of concern would even be eliminated by such a measure. A more rational approach which does not adversely affect market performance is to enhance the regulatory framework that is already used to maximize the likelihood that those attempting improper trading practices will be caught and that they will be punished severely. The Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange have such a framework in place and are enhancing it at considerable expense to ensure that users of the markets are provided with the transaction services they require without the fear of abuse.

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Appendix A

EXAMPLES OF TRADING TECHNIQUES EMPLOYED BY BROKER TRADERS

The principal benefits of broker trading are two fold. First, because the broker trader is permitted to trade for his own account, he is able to give his customers better order execution service. Second, in the course of seeking the best execution of his own customers' orders, he adds liquidity to the market and an important element of competition which keeps the bid/ask spreads narrow and costs low for all customers of the market.

In this appendix, these benefits will be illustrated through the description of certain trading techniques employed by broker traders. This is not an exhaustive description of all techniques used by broker traders.

Techniques Employed by Broker Traders to Provide their Customers Better Brokerage Service

1. A Broker Trader Disguises his Intentions in Filling a Customer Order to Obtain a Better Price

As part of his inventory hedging strategy, the manager of a grain firm submits an order to his broker trader to sell two million bushels of corn for delivery in May at the current market price. The customer hopes to obtain as high a price as possible yet he also needs prompt execution of the order since, until he is hedged, he is exposed to the possibility that the value of his inventory will fall.

Several thoughts run through the broker trader's mind when he receives this order. The broker trader knows that, on this day, offering to sell such a large quantity of corn in one trade would depress the market price substantially, and result in a very low price for his customer. Local traders would initially back away from taking the other side of the trade, recognizing that the broker trader had superior information and that by trading with him, they might incur a large loss. Furthermore, the broker trader feels that even if he divides the total order into smaller pieces (say, four trades of 500,000 bushels each), the market price will still be forced successively lower with the execution of each trade, yielding an unsatisfactorily low net price for his customer. Finally, the broker trader knows that other traders are aware that he often executes trades for large agricultural customers. He knows that if the other traders detect that he has a large sell order to execute (i.e., that he is trying to sell a large quantity of corn at as high a price as possible), they will not accommodate him immediately but rather will hold back, force the broker trader to lower the price at which he offers to sell for the customer, and buy from him only when the price reaches a lower level which is more satisfactory to them (and less satisfactory to the customer).

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When the broker trader receives the order, the market price of May corn is bid: \$2.65/bushel, offer: \$2.66/bushel.^{1/} Because it is a market order, he immediately begins working to execute it. To disguise his intent to sell, he bids (signals an intent to buy) at \$2.65/bushel for 500,000 bushels. This is merely a ploy. He has no intention to buy corn, but he hopes to convince other traders in the pit (i.e., traders with risk capital who he hopes will eventually buy part of his customer's order) that he does. He hopes no one will sell him corn but if they do, the trade will be for his own account.

In this case, his strategy works. No one sells corn to him and after a time he withdraws his bid. Other traders think his interest is on the buy side. Next he offers to sell 500,000 bushels of his customer's order at \$2.65 1/2 per bushel. This is above the current \$2.65/bushel bid price at which traders in the pit are buying corn. However, one trader the pit considers that the purchase of 500,000 bushels at \$2.65 1/2 per bushel is an acceptable transaction and commits his risk capital to the purchase. Thus, the prevailing bid price rises to \$2.65 1/2 per bushel. The broker trader knows that if he had not signalled an intention to buy previously (thus signalling an indication of information that could raise prices), the other trader would have been less likely to buy this quantity of corn at a price above the previous bid price.

The broker trader offers another 500,000 bushels at 2.65 1/2 per bushel but no one buys it. Other traders want him to lower his price. Because the customer needs prompt execution of the order to protect the value of his inventory, the broker trader reduces his offer price to \$2.65/bushel. He is able to find a buyer -- perhaps the same buyer.

Now half of the customer order is executed at a net price of \$2.65 1/4 per bushel, 1/4¢ above the prevailing bid price when the order entered the pit. However, the broker trader senses that the other traders have begun to realize that he is really interested in selling, rather than buying. The broker trader is concerned that if he offers to sell more of the customer's order in the current market environment, prices will drop quickly and he will not be able to execute the remaining one million bushels of the customer order at an acceptably high price. Again seeking to confuse opposing traders as to his true intentions, he bids for 500,000 bushels at \$2.64/bushel, the level to which the prevailing bid has fallen. No one sells to him. He raises his bid to \$2.64 1/2, attempting to signal firmness to the market before executing the remaining one million bushels of his customer's order.

^{1/} Traders in the pit are currently buying corn at \$2.65/bushel and selling corn for \$2.66/bushel. Thus, a customer wanting to sell corn at that moment could do so for \$2.65/bushel; a customer wanting to buy, could do so for \$2.66/bushel.

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This time, another trader sells to him at this price. Because this transaction was not requested by his customer, it necessarily is considered his proprietary trade. However, he succeeded in strengthening the market and masking the fact that he has one million bushels to sell. At this point he offers the remainder of the customer order and is successful in filling it at \$2.64 1/2 per bushel, the prevailing bid.

Summary

A broker who is unable to trade for his own account would not be able to disguise his intentions in this way. Each time the broker in the example attempted to mislead the other traders (and set up conditions for an advantageous execution of his customer's order) by signalling an intention to trade which was not consistent with the customers wishes, he faced the risk that another trader in the pit would trade with him. Such a trade could ultimately be profitable or it could result in a loss. Either way, it is necessarily a proprietary trade, making the broker a "broker trader", by definition. The broker who does not disguise his customers' intentions in this way will not take the risk of having unprofitable proprietary trades. However, in the example, if the trader had not disguised his customer's intentions, the order would certainly have been executed at a much lower price, to the customer's disadvantage.

2. A Broker Trader "Legs" a Spread to Obtain a Better Price

An investor submits an order to his broker trader to establish a spread position between June Treasury Bond futures and June 10-year Treasury Note futures at the current market differential. The Treasury Note price exceeds the Treasury Bond price and he expects that the spread will widen further in light of current market fundamentals. Thus, he wants to buy Treasury Notes and sell Treasury Bonds at the narrowest possible price differential to provide him with the greatest opportunity for profit if the spread widens as he expects.

When the broker trader receives the order, the market price for June Treasury Notes is 91 23/32 and the price of June Treasury Bonds is 87 18/32.2/ The current spread is thus 4 5/32. The broker trader has two options -- he can execute the entire trade (i.e., obtain both sides of the spread in one transaction) with another trader who specializes in spread transactions if the price is satisfactory for the customer; or he can buy the Treasury Notes and sell the Treasury Bonds in two separate transactions (i.e., he can "leg" the spread). The first option is easier for the broker trader but since

2/ The price of these instruments is expressed as a percentage of par value of \$100,000. Thus, the Treasury Note contract is currently priced at \$91,718.75 and the Treasury Bond contract is currently priced at \$87,562.50.

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traders who specialize in spread trading often charge a premium for providing the complete spread, the price may not be the most advantageous for the customer. "Legging" the spread (i.e., obtaining the desired spread in two separate transactions) is more time consuming, difficult and risky for the broker trader, but a better execution for the customer is possible. If the market moves sharply while he is legging the spread and he is unable to execute a spread at terms which are at least as favorable for the customer as the complete spread, he may have to abandon his attempt to leg the spread, take the unfavorable spread into his own account (at a loss) and either obtain the spread from a spread trader in the pit or try again to leg the spread. He also knows that if, over a period of time he does not leg his customer spreads quickly as well as effectively, he might lose brokerage business to possibly less skillful brokers who would execute the spread order more quickly (albeit at a less advantageous price) by trading directly with the spread trades.

The broker trader finds that he can obtain the spread for his customer from a spread trader at $4 \frac{6}{32}$, slightly above the $4 \frac{5}{32}$ differential based on the current individual Treasury Note and Treasury Bond prices. The broker trader wants to give his customer the best possible execution in hopes of retaining his brokerage business. He thus opts to leg the spread in an attempt to save the customer $1/32$ or \$31.25/contract. He first buys the Treasury Note leg at the prevailing price of $91 \frac{23}{32}$. However, when he attempts to sell Treasury Bonds, he finds the price has fallen to $87 \frac{16}{32}$. If he sells the Treasury Bond leg at this price the spread will be $4 \frac{7}{32}$, wider than the complete spread he could have purchased. Now, the Treasury Note price falls, as well, to $91 \frac{21}{32}$ and the Treasury Note-Treasury Bond spread returns to a $4 \frac{5}{32}$ differential. The spread trader is still making the spread available at $4 \frac{6}{32}$. The broker trader still seeks to obtain the spread for his customer at the more favorable $4 \frac{5}{32}$ differential and thus begins to leg the spread again. He takes the previous Treasury Note purchase at $91 \frac{23}{32}$ into his "error" account since it now has no part in his legging strategy. (At this point, he thinks he may have to take a loss on this transaction since Treasury Note prices have fallen to $91 \frac{21}{32}$.) This time he is successful in legging the spread for the customer, buying Treasury Notes at $91 \frac{21}{32}$ and selling Treasury Bonds at $87 \frac{16}{32}$. The customer receives a spread execution at $4 \frac{5}{32}$, narrower than the $4 \frac{6}{32}$ offered by the spread trader, and thus saves $1/32$ or \$31.25/contract. The broker trader attempts to offset the Treasury Note position in his error account, taken in his initial attempt to leg the customer spread, over the course of the trading day. He may or may not be successful in doing this.

Summary

A broker who was not a broker trader would probably have obtained for the customer the 4 6/32 spread available from the spread trader. It would have been the easiest and least risky route for him to take, but it would have been more expensive for the customer. The broker trader who is permitted to take a trade into his own account can, if he wishes, take a risk in the interest of providing the best execution for the customer. In this case, the broker trader took the risk and (at least initially) suffered a loss. The customer received a better price, however, and will probably continue to channel his brokerage business through the broker trader. The broker trader considers the loss he incurred on this trade to be a cost of doing business.

3. A Broker Trader Employs a Strategy to Obtain the Most Favorable Inter-month Spread Relationship

As part of his grain merchandising operation, a grain elevator wishes to establish a May/November soybean spread, expecting the spread to narrow. Specifically, the grain elevator wishes to sell 350,000 bushels of May soybeans and buy 350,000 bushels of November soybeans at the current market price (i.e., He wants to sell the May/November spread). When the broker trader receives his customer's order, the current market prices for spreads in the Soybean futures pit are:

May/November	25 1/2¢ bid/26 1/2¢ offered
July/May	3¢ bid/3 1/2¢ offered
July/November	29 1/2¢ bid/30¢ offered

The broker trader observes that another broker is bidding 29 1/2¢ for 500,000 bushels of the July/November spread (i.e., to buy 500,000 bushels of July soybeans and sell 500,000 bushels of November soybeans). He also observes that several local traders are bidding 25 1/2¢ for the May/November spread (buy May, sell November).

The broker trader bids 26¢ for 200,000 bushels of the May/November spread, above the prevailing 25 1/2¢ bid for the spread. A local trader who is trading spreads sees this and raises his own bid for the May/November spread to 26¢, as well. At this point, the broker trader withdraws his bid and sells 350,000 bushels of the spread to the local trader (i.e., sells the May and buys the November, as the customer wishes) at 26¢. The broker trader has thus achieved for his customer a price which is 1/2¢ better than the market price for the spread which prevailed when he received the customer's order (i.e., He was able to sell the spread for 26¢ rather than 25 1/2¢).

To fully understand this example, it is necessary to understand the motivations of the local trader. He raised his bid to 26¢ for the May/November spread, following the

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broker trader, after observing a profit opportunity in the other available spreads. He felt that if he could buy the May/November spread (buy May and sell November) for 26¢, he could then sell the July/November spread (sell July and buy November) for 29 1/2¢ to the broker bidding that price for 500,000 bushels. This would leave the local trader with a May/July spread (long May and short July) at 3 1/2¢, which is the current offer price for that spread. This is an advantageous, and potentially profitable, position for him. Thus, the broker trader's tactic of bidding above the market bid price for the May/November spread caused the local trader to evaluate market opportunities for himself and, finding a profitable one, raised his own bid as well, eventually buying the customer's spread from the broker trader.

Summary

The broker trader risked buying the May/November spread at 26¢ because he was hoping to bring together information conveyed by several market interests and elicit a favorable customer execution. If another trader had sold the spread to him at that price, the broker trader would have had to offset this purchase somehow, possibly at a loss. He would have had to absorb any loss himself. However, as he had hoped, his tactic conveyed information to the market that elicited an increased bid price for the spread the customer wished to sell. The customer received a price which was 1/2¢/bushel better on 350,000 bushels, for a reduction in cost of \$1750. The customer would not have benefitted by the higher price if his order had been executed by a broker who was not a broker trader.

How These Techniques Enhance Liquidity

In each of these examples, the broker trader has enhanced liquidity in the pit as he has endeavored to obtain the best order execution for the customer.

When the broker trader disguises his trading intentions (i.e., those of his customer) as in the first example, the bids and offers he makes in the course of the deception provide more trading opportunities for others in the pit, and hence, increase liquidity. While he may hope that no other traders accept these bids or offers, he runs the risk that they will. Brokers who are not broker traders would not provide this additional liquidity.

In the second example, the broker does not wish to accept the spread offered by the spread traders but instead "legs" the spread to obtain a more favorable spread for his customer. In this case, the broker trader promotes liquidity by counterbalancing the offers of other traders. If the offers of the spread traders were continuously accepted by others in the pit, the premium charged by these traders would not be challenged. The broker trader in the example did not accept the spread traders' offer and instead bypassed them to accomplish the desired spread himself. This

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imposes discipline on the spread traders who may decide to reduce the premium in the interest of attracting others to trade with them. The broker who is not a broker trader would not be able to provide the same countervailing element in the pit.

The broker trader in the third example effectively brought the information and interests signalled by other traders together with the information and interest signalled by his customer's order to negotiate an agreement that could give his customer a superior price. His only vehicle for negotiation is bidding and offering openly in the pit. He cannot secretly gather information from each of several other market participants separately and then put together a deal. Prearrangement is prohibited and the speed of pit trading generally makes extended negotiation totally impractical. However, by bidding and offering for various trades, the broker trader can effectively perform a negotiation that brings buyers and sellers together at a better price for his customer. This is the essence of the broker's function in any market.

These examples illustrate the fundamental mechanisms at play in the futures pit, as well as the role of broker traders in executing their customers' orders at the best possible price. There are many different interests, with many different trading perspectives and kinds of information present in the pit. A similarly diverse set of interests is present in other environments where broker negotiations take place. Consider real estate markets for example. Both the real estate markets and the futures or options pit process diverse information, permit compromises among competing interests and facilitate final transactions at acceptable terms. But negotiations regarding price of a soybean spread can be completed in a matter of seconds; real estate brokers perform the same function at a much slower pace through negotiations that can take months. The broker trader, through his efficient management of the information which the customer order brings into the pit and his negotiation by means of open (not hidden or prearranged) bids and offers with market interests which are competing with his customer, brings these interests together in the form of an agreed upon transaction price.

Appendix B

BROKER TRADERS AND MARKET LIQUIDITY

The Exchanges' staff have undertaken an analysis of the effects of the broker trader system on market liquidity. Only preliminary findings are reported at this time due to the time limitations of the CFTC request and the complexity of the issue. The Exchanges will be continuing their analysis and will present any significant findings from this research to the CFTC.

Data Overview

The Exchanges examined market activity for a 5-day period in the fourth quarter of 1988 -- October 3 to October 7. This week approximated the average fourth quarter volume for the three exchanges combined.

The CBOT chose the following markets for examination:

U.S. Treasury Bond Futures, Day Session
Wheat Futures
1,000 oz. Silver Futures

These contracts are the highest volume contract (T-Bonds), a medium volume contract (wheat) and a low volume contract (silver). They provide the ability to contrast activity in interest rate and agricultural futures contracts.

For its analysis the MACE chose:

U.S. Treasury Bond Futures
Wheat
Deutsche Mark

These contracts represent high, average and low volume contracts at the MACE.

Finally, CRCE is submitting its one contract -- Rough Rice. Table 1 shows the volume exhibited by each contract on the examined days and the average volume for each contract.

Data Analysis

For each trading session, all traders were identified based on the CFTC's definition; that is, a trader was identified as a broker trader if he executed a CTI1 plus a CTI2, CTI3 or CTI4 trade during the session.^{1/} Based on this definition all traders were

^{1/} A CTI1 trade is a trade for one's own account, a CTI2 trade is for a clearing member's house account, a CTI3 is a trade for another member on the floor, or an account controlled by such other member and a CTI4 is a trade for any other type of customer.

TABLE I
VOLUMES OF EXAMINED CONTRACTS

	DATE:	10/03	10/04	10/05	10/06	10/07	AVERAGE
CBT	T-Bonds (Day)	255,889	163,188	313,543	164,632	450,763	269,603
	Wheat	9,707	20,183	12,212	19,602	16,751	15,691
	1000oz Silver	2,076	558	810	1,532	3,155	1,626
MACE	T-Bonds	4,269	3,017	4,720	2,695	7,759	4,492
	Wheat	387	850	1,263	1,122	435	811
	D-Mark	288	109	914	136	80	305
CRCE	Rough Rice	24	99	26	11	145	61

defined as broker traders or other traders and their activity was examined for five different time brackets for each trading session. Specifically, market activity was examined for the half-hour brackets with the lowest volume and the highest volume, the first five minutes of trading (open), the last five minutes of trading (close) and trading across the entire session.

Overview

An overview of the relationship of the broker trader to the market is provided by Table 2. This table shows an aggregated analysis of broker trader activity over all trading sessions in the examined week.

CBOT. For the examined CBOT contracts broker traders represented about 25% to 36% of the traders executing trades during a trading session. The highest concentration of broker traders was found in the silver contract where on average 36.4% of the traders were broker traders.^{2/} In contrast, broker traders constituted the smallest percentage of traders in T-Bonds (25.5%). In addition to constituting a significant portion of the trader population, broker traders account for a majority of the trades and volume in the CBOT contracts. Over the entire period, broker traders executed between 48% and 90% of all trades and volume in most of the contracts. Trades by broker traders as a percent of total trades varied from a high of 89.7% in silver to a low of 47.6% in the T-Bonds. Volume from broker traders as a percent of total volume varied from 86.9% in silver to 52.5% in the T-Bonds. These data indicate that broker traders are extremely important in the CBOT contracts.

As would be expected, volume exhibits the major role of broker traders when examined on the basis of CTI codes. Broker traders executed 25% to 80% of the CTI1 trades over the examined period. This percentage ranged from a low of 25.2% in T-Bonds to a high of 80.0% in silver. These CTI1 trades represent the speculative capital on the floor and are the cornerstone of the liquidity that futures markets provide. The market share of these trades held by broker traders is prima facie evidence of their integral role in the provision of futures market liquidity.

- 2/ Due to the use of percentages, wide swings are exhibited in the low volume contracts with few traders. For example, a one trader change in a 10 trader pit makes for a substantial swing. The maximum number of broker traders and all traders in the four lowest volume contracts were, as follows:

<u>Contract</u>	<u>Maximum Number Broker Traders</u>	<u>Maximum Number All Traders</u>
Silver	5	16
MACE Wheat	3	35
D-marks	5	23
Rice	3	8

Broker traders dominate brokerage execution in these markets accounting for about of 90% of all brokered trades. The broker trader share of outside customer executions (CTI4) ranges from a low of 93.2% in T-Bonds to a high of 97.6% in silver. The broker trader share of executions for another member on the floor (CTI3) is comparable, ranging from 83.2% in wheat to 85.3% in silver. Broker traders' market share of clearing member house account executions (CTI2) ranges from 80.1% in wheat to 99.9% in silver.

MACE. For the examined MACE contracts broker traders represented about 7 to 17% of the traders executing trades during a trading session. The highest concentration of broker traders was found in the D-mark contract with an average of 17.2% of the traders being broker traders. In contrast, broker traders constituted the smallest percentage of traders in wheat with 7.4% being broker traders.^{3/}

Despite constituting a minority of the trader population, the broker traders account for about half of the trades and volume in two of the MACE contracts, T-Bonds and D-marks, plus 40% and 27%, respectively, of that in wheat. The share of trade activity accounted for by broker traders varied from a high of 51.1% in D-marks to a low of 40.1% in T-Bonds. Broker traders' share of volume varied from a high of 52.7% in D-marks to a low of 26.6% in wheat. The low number of traders and their substantial volume indicate that broker traders are some of the largest traders in the MACE contracts.

Volume composition, when examined on the basis of CTI, illuminates the role of broker traders. Broker traders provided 8% to 33% of the CTI1 trades executed over the examined period. This percentage ranged from a low of 8.2% in wheat to a high of 32.9% in D-marks. These CTI1 trades by broker traders show a substantial contribution to futures market liquidity.

Broker traders dominate brokerage execution in these markets accounting for in excess of 75% of the brokered trades in the T-Bonds and D-marks. The broker trader share of outside customer executions (CTI4) ranges from a low of 88.2% in wheat to a high of 99.5% in D-marks. Broker traders' share of executions for another member on the floor (CTI3) is comparable in T-Bonds (85.7%) and D-marks (94.9%), but low in wheat (14.3%). Broker traders' market share of clearing member house account executions (CTI2) is at 87.7% in T-Bonds, at 42.4% in D-marks and an inexplicable 0.9% in wheat.

CRCE. In the CRCE's rough rice contract broker traders represented about 33% of the traders executing trades during a trading session.

^{3/} The difference between CBOT and MACE wheat has no ready explanation and needs further investigation.

These broker traders account for 48.9% of the trades and 46.1% of the volume in the rice contract. These data indicate that broker traders are a major component of the rice market. Broker traders provided 53% of the CTI1 trades executed over the examined period; that is, they represented half of the speculative capital on the floor. Broker traders market share of outside customer brokerage (CTI4) in the rice contract was comparable, accounting for almost 47% of the brokered trades. Broker traders' share of executions for other members (CTI3) was 95.7%. Finally, broker traders' market share of clearing member trading account executions (CTI2) is lower at 16.5%.

Contract Characteristics and Broker Traders

The relatively small sample size of examined contracts makes it difficult to readily discern relationships between contract characteristics, such as average volume and underlying commodity, and broker traders' activity. These relationships require further study; however, preliminary observations are as follows:

CBOT. The highest volume CBOT contract, T-Bonds, exhibited comparably high broker trader activity; however, wheat had the highest level of broker trader activity (Table 2). Our presumption is that the slightly lower activity in the T-Bonds relative to wheat is reflective of the importance of spreading in the wheat contract, as noted later.^{4/}

The low volume contract (silver) is a sustained low-volume contract that has a high overall level of broker trader activity that would seem necessary to sustain the contract. This deserves further research.

MACE. No clear pattern was seen in the MACE contracts. The high volume contract, T-Bonds, and the low volume contract, D-marks, exhibited similar patterns of broker trader activity. Wheat, the moderate volume contract, stood out as an anomaly especially in light of the CBOT wheat contract. This also deserves greater examination.

CRCE. The CRCE's rough rice is a low volume agricultural contract exhibiting a substantial market share by broker traders.

Bracket Analysis

Intra-day analysis of broker traders share of market activity is revealing as regards the role of the broker trader system. Four periods were examined for each trading session, as explained earlier, the low and high half hour bracket, and the first and last five minutes of trading.

^{4/} A preliminary examination of activity in the MMI futures contract shows substantially less broker trader participation. This is a subject for further investigation.

CBOT. Intra-day market activity for the three CBOT contracts -- T-Bonds, wheat and silver is shown in Tables 3 and 4.

The data indicate that the relative number of broker traders in the active pits increases substantially between high and low volume brackets. This variance is due to the different responsibilities of the broker trader as opposed to the pure trader. The broker trader has the responsibility to serve his customers. This responsibility means that the broker trader must be present in the pit at all times whether volume is high or low. In contrast, the pure trader is answerable only to himself. If the pure trader doesn't feel that volume warrants his presence in the pit at a particular point in time, he can leave. Since fewer profit opportunities are available in low volume periods, fewer pure traders are present. Also note that broker traders generally accounted for a higher proportion of the trading population during the close relative to the open, since they must be prepared to meet brokerage demand whereas, pure traders are free to leave.

In wheat, there is little variation in the average share of volume executed by broker traders -- across the low, high and open; however, close volume share increases. In contrast, T-Bond broker traders have a greater share of volume at both the close and low relative to the open and high bracket. Observations on broker trader activity over all silver brackets is difficult due to low participation at times and absence of CT11 volume at many times.

The importance of broker traders to liquidity in the low bracket is seen in T-Bonds and wheat. On average, broker trader CT11 volume had its largest market share in wheat's low bracket providing 40.1% of the speculative capital and its second largest market share in T-Bonds' low bracket at 22.1%. Not only does their overall share increase at this time, but the intensity of their liquidity (CT11) vs. brokerage (CT12, 3 and 4) trade increases at this time to 27 and 33% of their trading activity in T-Bonds and wheat, respectively. These data lend evidence that, during periods of lower brokerage demand, broker traders execute relatively more personal trades, enhancing their contribution to market liquidity.

MACE. Intra-day market activity for the three MACE contracts -- T-Bonds, wheat and D-marks is shown in Tables 5 and 6. Please note that due to the low number of traders in these contracts, broker trader activity was not consistently observed.

The data indicate that the relative number of broker traders in the pits generally increases substantially between high and low volume brackets. This variance is again due to the different responsibilities of the broker trader as opposed to the pure trader, as explained above. In fact, MACE T-Bonds and wheat evidence this behavior even more strongly than the CBOT contracts.

In wheat, there was an increase in the share of volume accounted for by broker traders in the low and close brackets relative to the high and open. In contrast, T-Bond broker traders have their

TABLE 3: BRACKET ANALYSIS - CBT

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN	DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
T-Bonds	Number of Broker Traders/Number of All Traders								Wheat	Number of Broker Traders/Number of All Traders							
Low	39.2	37.1	38.4	38.6	37.8	38.2	39.2	37.1	Low	52.8	46.9	60.0	45.3	57.5	52.5	60.0	45.3
High	32.9	28.8	34.4	31.0	30.5	31.5	34.4	28.8	High	44.8	40.8	38.1	32.4	38.9	39.0	44.8	32.4
Open 5	30.9	28.6	31.5	28.5	32.5	30.4	32.5	28.5	Open-5	48.1	50.0	40.0	39.6	45.8	44.7	50.0	39.6
Close 5	55.2	41.4	66.7	66.7	62.5	58.5	66.7	41.4	Close-5	55.6	25.0	60.0	54.5	71.4	53.3	71.4	25.0
Broker Traders' Volume/All Volume									Broker Traders' Volume/All Volume								
Low	51.3	43.5	48.2	39.8	46.8	45.9	51.3	39.8	Low	67.4	54.6	67.9	44.9	72.3	61.4	72.3	44.9
High	39.4	37.5	43.3	48.4	44.9	42.7	48.4	37.5	High	64.5	65.6	53.2	55.8	67.6	61.3	67.6	53.2
Open 5	35.5	31.5	36.2	34.3	45.1	36.5	45.1	31.5	Open-5	67.5	59.8	43.0	54.0	74.5	59.8	74.5	43.0
Close 5	66.6	51.0	56.5	57.7	64.6	59.3	66.6	51.0	Close-5	69.5	41.0	75.0	58.9	84.8	65.8	84.8	41.0
Broker Traders' CTII Volume/All CTII Volume									Broker Traders' CTII Volume/All CTII Volume								
Low	23.4	21.7	20.5	21.7	23.3	22.1	23.4	20.5	Low	34.5	39.1	40.4	21.6	64.8	40.1	64.8	21.6
High	12.3	12.5	16.1	18.8	16.4	15.2	18.8	12.3	High	40.8	39.0	35.2	19.7	47.2	36.4	47.2	19.7
Open 5	12.8	14.5	17.3	14.2	14.3	14.6	17.3	12.8	Open-5	44.8	46.6	29.0	24.0	54.3	39.7	54.3	24.0
Close 5	35.4	6.7	13.0	42.1	28.6	25.2	42.1	6.7	Close-5	39.4	0.0	28.7	25.5	55.0	29.7	55.0	0.0
Broker Traders' CTII Volume/All Broker Traders' Volume									Broker Traders' CTII Volume/All Broker Traders' Volume								
Low	19.8	28.9	23.7	33.1	30.4	27.2	33.1	19.8	Low	21.0	43.0	26.7	21.4	52.5	33.0	52.5	21.0
High	19.6	20.0	23.4	21.4	20.3	21.0	23.4	19.6	High	30.7	23.7	37.5	15.9	34.0	28.4	37.5	15.9
Open 5	25.5	35.9	33.0	28.5	18.2	28.2	35.9	18.2	Open-5	35.8	50.5	37.1	21.5	36.3	36.2	50.5	21.5
Close 5	19.9	6.7	11.5	24.1	20.1	16.5	24.1	6.7	Close-5	31.3	0.0	28.1	22.4	18.8	20.1	31.3	0.0

Note: Blank cells are due to either no broker trader activity or no CTII trades by broker traders.

TABLE 4: BRACKET ANALYSIS - CBT

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
Silver	Number of Broker Traders/Number of All Traders							
Low		33.3		40.0	66.7	46.7	66.7	33.3
High	11.1		11.1	28.6	57.1	27.0	57.1	11.1
Open-5		25.0	14.3	60.0	66.7	41.5	66.7	14.3
Close-5	16.7			28.6	66.7	37.3	66.7	16.7
Broker Traders' Volume/All Volume								
Low		10.5		40.0	81.8	44.1	81.8	10.5
High	5.3		2.3	3.2	71.1	20.5	71.1	2.3
Open-5		25.0	3.3	62.5	75.0	41.5	75.0	3.3
Close-5	5.5			4.4	75.0	28.3	75.0	4.4
Broker Traders' CT11 Volume/All CT11 Volume								
Low		11.1		23.1	80.0	38.1	80.0	11.1
High	19.7			67.7	58.0	48.5	67.7	19.7
Open-5		33.3		76.9	66.7	59.0	76.9	33.3
Close-5	11.4			15.3	50.0	25.6	50.0	11.4
Broker Traders' CT11 Volume/All Broker Traders' Volume								
Low				37.5	88.9	63.2	88.9	37.5
High					24.8	24.8	24.8	24.8
Open-5		100.0		100.0	66.7	88.9	100.0	66.7
Close-5					33.3	33.3	33.3	33.3

Note: Blank cells are due to either no broker trader activity or no CT11 trades by broker traders.

TABLE 5: BRACKET ANALYSIS - MACE

DATE	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN	DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
T-Bonds	Number of Broker Traders/Number of All Traders								Wheat	Number of Broker Traders/Number of All Traders							
Low	35.7	36.4	50.0	28.6	21.6	34.5	50.0	21.6	Low	33.3	50.0	22.2	33.3		34.7	50.0	22.2
High	16.5	16.7	19.4	17.9	16.8	17.4	19.4	16.5	High	9.1	11.1	20.0	14.3	10.0	12.9	20.0	9.1
Open 5	20.0	16.7	33.3	50.0	40.0	32.0	50.0	16.7	Open 5	28.6	15.4	28.6	27.3	10.0	22.0	28.6	10.0
Close 5	50.0	41.7	44.4	42.9	44.4	44.7	50.0	41.7	Close 5		33.3	25.0	22.2	50.0	32.6	50.0	22.2
Broker Traders' Volume/All Volume									Broker Traders' Volume/All Volume								
Low	59.4	38.6	50.7	51.9	21.1	44.4	59.4	21.1	Low	20.0	28.6	23.0	21.6		23.3	28.6	20.0
High	38.6	39.2	35.6	27.9	45.7	37.4	45.7	27.9	High	8.0	14.4	33.4	17.9	18.0	18.3	33.4	8.0
Open 5	13.2	22.2	23.3	50.0	34.0	28.5	50.0	13.2	Open 5	30.0	15.7	25.0	18.3	14.0	20.6	30.0	14.0
Close 5	47.3	52.4	41.7	75.4	36.3	50.6	75.4	36.3	Close 5		16.7	14.3	11.9	50.0	23.2	50.0	11.9
Broker Traders' CTII Volume/All CTII Volume									Broker Traders' CTII Volume/All CTII Volume								
Low	4.0	29.7	15.0		3.0	12.9	29.7	3.0	Low	5.9	16.7	24.5	13.8		15.2	24.5	5.9
High	16.6	6.0	7.5	4.0	8.6	8.5	16.6	4.0	High	1.9	5.9	5.3	3.7	4.2	4.2	5.9	1.9
Open 5	13.2		17.9	50.0		27.0	50.0	13.2	Open 5	3.4	4.4	15.4	6.1	1.1	6.1	15.4	1.1
Close 5		47.4	16.7	3.3	2.6	17.5	47.4	2.6	Close 5						0.0	0.0	0.0
Broker Traders' CTII Volume/All Broker Traders' Volume									Broker Traders' CTII Volume/All Broker Traders' Volume								
Low	2.6	64.7	17.1		8.9	23.4	64.7	2.6	Low	25.0	33.3	52.2	57.9		42.1	57.9	25.0
High	28.6	8.4	14.1	10.4	10.1	14.3	28.6	8.4	High	10.3	8.9	15.1	14.5	12.2	12.2	15.1	8.9
Open 5	100.0		71.4	100.0		90.5	100.0	71.4	Open 5	8.3	21.4	54.5	26.7	5.3	23.2	54.5	5.3
Close 5		41.9	20.0	1.1	1.7	16.2	41.9	1.1	Close 5						0.0	0.0	0.0

Note: Blank cells are due to either no broker trader activity or no CTII trades by broker traders.

TABLE 6: BRACKET ANALYSIS - MACE

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
D-Mark	Number of Broker Traders/Number of All Traders							
Low					50.0	50.0	50.0	50.0
High	35.7	25.0	44.4	50.0	12.5	33.5	50.0	12.5
Open-5	50.0	50.0		50.0		50.0	50.0	50.0
Close-5		33.3	50.0	25.0	50.0	39.6	50.0	25.0
Broker Traders' Volume/All Volume								
Low					50.0	50.0	50.0	50.0
High	61.3	20.5	57.4	76.9	27.8	48.8	76.9	20.5
Open-5	50.0	50.0	100.0	50.0		62.5	100.0	50.0
Close-5		25.0	50.0	25.0	50.0	37.5	50.0	25.0
Broker Traders' CT11 Volume/All CT11 Volume								
Low						0.0	0.0	0.0
High	53.2	18.2	73.8	62.5	12.0	43.9	73.8	12.0
Open-5			100.0			100.0	100.0	100.0
Close-5		50.0		33.3		41.7	50.0	33.3
Broker Traders' CT11 Volume/All Broker Traders' Volume								
Low						0.0	0.0	0.0
High	42.0	25.0	72.7	50.0	30.0	43.9	72.7	25.0
Open-5			50.0			50.0	50.0	50.0
Close-5		100.0		100.0		100.0	100.0	100.0

Note: Blank cells are due to either no broker trader activity or no CT11 trades by broker traders.

greatest share of volume at the close relative to the other brackets.

CRCE. Intra-day market activity for rough rice is shown in Table 7. The data are difficult to interpret due to the low number of traders and broker traders (see footnote 2).

Back Month Liquidity

Broker trading has been traditionally associated with the enhancement of back month liquidity due to broker traders' ability to "leg in" a spread (see Appendix A for an explanation of "legging"). As a preliminary examination, the composition of average back month activity for the week was examined with regard to broker trader executions.

CBOT. Wheat, T-bonds and silver which were examined for the CBOT, have particular distinctions due to differences in the underlying cash market. Table 8 shows the aggregated weekly activity in wheat for each expiration. Wheat is a carrying charge market where intermonth spreads vary due not only to interest rates but storage charges, inventory demands, crop years, etc.. These multiple factors lead to substantial volatility in the price relationships between months. This spread volatility creates a hedge demand and a demand for brokerage services.

Table 8 shows that broker traders account for a substantial portion of the back month activity for the examined period. These data indicate that the broker trader is a major marketmaking force in these back months with regard to overall volume, accounting for up to 54%; speculative capital from the floor (CT11 trades), generally providing 21% to 33%; and brokerage, providing up to 83%.

The wheat contract stands in stark contrast to contracts that exhibit less variable pricing relationships over time. For example, back month prices are determined almost exclusively by interest rates in the T-bond and silver markets; therefore, there is substantially less hedge demand for spread positions within the market. Rather back month demand for rollovers is reflected in first deferred month (intermarket spreads are a different matter and cannot be observed from these data.) This rollover demand and reduced spread demand is seen in the market activity data for these contracts (Table 9). There is activity in the first deferred expiration but very little or no broker trader activity in the further deferred months of these CBOT contracts.

MACE. Only MACE wheat was examined for back month liquidity from broker traders (Table 10). Although broker trader activity was substantially lower in MACE wheat relative to CBOT wheat, MACE wheat still exhibits a substantial contribution by broker traders to back month liquidity. Broker traders generally account for 40% to 50% of the back month volume, 17% to 36% of the speculative capital provided to those back months (CT11 trades) and 61% to 77%

TABLE 7: BRACKET ANALYSIS - CRCE

DATE:	10/03	10/04	10/05	10/06	10/07	AVE.	MAX	MIN
R. Rice	Number of Broker Traders/Number of All Traders							
Low							0.0	0.0
High		14.3	14.3		28.6	19.1	28.6	14.3
Open-5	50.0	50.0	50.0		50.0	50.0	50.0	50.0
Close-5					32.3	32.3	32.3	32.3
Broker Traders' Volume/All Volume								
Low						0.0	0.0	0.0
High		9.5	9.5		18.0	12.3	18.0	9.5
Open-5	50.0	50.0	50.0		50.0	50.0	50.0	50.0
Close-5					47.6	47.6	47.6	47.6
Broker Traders' CT11 Volume/All CT11 Volume								
Low						0.0	0.0	0.0
High		12.5	12.5		1.2	8.7	12.5	1.2
Open-5	50.0	69.2			50.0	58.4	69.2	50.0
Close-5						0.0	0.0	0.0
Broker Traders' CT11 Volume/All Broker Traders' Volume								
Low						0.0	0.0	0.0
High		8.3	50.0		2.6	20.3	50.0	2.6
Open-5	100.0	11.5			100.0	70.5	100.0	11.5
Close-5						0.0	0.0	0.0

Note: Blank cells are due to either no broker trader activity or no CT11 trades by broker traders.

TABLE 8

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR
CBOT WHEAT CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CT11 SHARE OF ALL CT11 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CT12,3,4) VOLUME	BROKER-TRDR CT11 SHARE OF ALL BROKER- TRDR VOLUME
CBOT				
10/3-10/7				
DEC '88	72%	53%	88%	35%
MAR '89	54%	31%	83%	31%
MAY '89	44%	21%	65%	24%
JUL '89	51%	30%	77%	32%
SEP '89	25%	33%	20%	50%
DEC '89	0%	0%	0%	0%

TABLE 9

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER TRADERS FOR
CBOT T-BONDS AND 1000 OZ. SILVER CONTRACTS

WEEK-LONG AVERAGES FOR
WEEK OF OCTOBER 3 THROUGH 7

CBOT T-BONDS	BROKER TRDR SHARE OF CONTRACT: ALL VOLUME	BROKER TRDR CT11 SHARE OF ALL CT11 VOLUME	BROKER TRDR SHARE OF ALL BROKERAGE (CT12,3,4) VOLUME	BROKER TRDR CT11 SHARE OF ALL BROKER TRDR VOLUME
DEC '88	52%	24%	89%	27%
MAR '89	26%	9%	38%	14%
JUNE '89	12%	7%	17%	26%
SEP '89	4%	0%	2%	12%
DEC '89	8%	4%	14%	29%
MAR '90	0%	0%	0%	0%
JUN '90	0%	0%	0%	0%
SEP '90	0%	0%	0%	0%
DEC '90	5%	4%	5%	42%
MAR '91	0%	0%	0%	0%
JUN '91	0%	0%	0%	0%
CBOT SILVER*				
DEC '88	87%	79%	90%	29%
FEB '89	22%	34%	1%	98%
APRIL '89	0%	0%	0%	0%
JUNE '89	0%	0%	0%	0%

* OCT '88 Deleted as delivery month.

TABLE 10

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR
MACE WHEAT CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CT11 SHARE OF ALL CT11 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CT12,3,4) VOLUME	BROKER-TRDR CT11 SHARE OF ALL BROKER- TRDR VOLUME
MACE				
10/3-10/7				
DEC '88	23%	4%	52%	10%
MAR '89	48%	20%	77%	21%
MAY '89	50%	36%	61%	33%
JULY '89	40%	17%	69%	23%
SEP '89	0%	0%	0%	0%

of the brokerage activity in these back months. Again note that the differences between the MACE and CBOT wheat markets bear further investigation. Also low volume in this market has a strong effect on these results.

CRCE. The rough rice market is similar in nature to the wheat markets and the back month contribution of broker traders is strong. Table 11 illustrates the contribution of the broker trader to back month liquidity in rice. The broker trader accounts for up to 40% of back month volume, 33 to 60% of the speculative capital (CTI1 trades) in those back months and up to 43% of back month brokerage. Again, these percentages are extremely volatile due to low volume.

Low and High Volume Days

CBOT. Broker trader activity for the nearby months of CBOT T-bonds, wheat and silver on the lowest and highest volume day of the week is shown on Tables 12, 13 and 14.

T-bond volume was lowest on October 4 and highest on October 7 (Table 12). As expected on the high volume day there was a larger trading population with more broker traders relative to the low volume day. Broker traders executed a larger proportion of all volume on the high volume day (49.6% vs. 41.8%). This increase in broker trader volume share occurred as, on average, each broker trader executed more than double the volume they did on the slower day with more and larger trades. On both days broker traders executed about one-third of their trades for their own accounts. For each customer category (CTI2 through 4), broker traders executed a slightly larger proportion of all trades on the high volume day relative to the low volume day as customers requested additional brokerage services.

Wheat volume was lowest on October 3 and highest on October 4 (Table 13). The number of all traders and the number of traders classified as broker traders on the high volume day were slightly higher than that of the low volume day. The share of all volume executed by broker traders on the high volume day was greater as each broker trader did more trades and larger trades. On the high volume day a slightly larger proportion of all customer trades (CTI2,3,4) were executed by broker traders. However, while broker traders did a larger share of CTI2 customers volume on the busy day, they did a smaller share of CTI3 and 4 volume on the busy day. Broker traders' share of CTI1 volume was about the same on both days. The ratios indicate that on the low volume day in wheat a greater percentage of broker trader activity was comprised of trading for their own account.

Daily volume in the relatively slow 1000 oz. silver contract can vary widely. While the total number of traders on the high volume day was just above that of the low volume day, the number of broker traders rose from one to five (Table 14). The share of all volume executed by broker traders on the high volume day was far greater than that of the low volume day. Volume and trades per

TABLE 11

ANALYSIS OF BACK-MONTH ACTIVITY OF BROKER-TRADERS FOR
CRCE ROUGH RICE CONTRACTS

	BROKER-TRDR SHARE OF ALL VOLUME	BROKER-TRDR CT11 SHARE OF ALL CT11 VOLUME	BROKER-TRDR SHARE OF ALL BROKERAGE (CT12,3,4) VOLUME	BROKER-TRDR CT11 SHARE OF ALL BROKER- TRDR VOLUME
CRCE				
10/3-10/7				
NOV '88	45%	47%	45%	28%
JAN '89	40%	60%	32%	42%
MAR '89	38%	33%	43%	42%

TABLE 12

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYS

CBOT T-BONDS		
DECEMBER EXPIRATION	LOW DAY: OCT 4	HIGH DAY: OCT 7
TOTAL VOLUME	163,188	450,753
(all expirations)		
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	644	693
NUMBER BROKER TRADERS	141	162
BROKER TRADERS/TOTAL TRDRS	21.9%	23.4%
BROKER TRADERS ONLY:		
NUMBER BROKER TRADERS	41.8%	49.6%
VOLUME PER TRADER	478	1273
TRADES PER TRADER	43	81
VOLUME PER TRADE	11.2	15.7
CT11 TRADES/ALL TRADES	38.4%	36.0%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	78.1%	82.5%
B-T CT11 VOLUME/ALL B-T VOLUME	21.7%	24.3%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	15.7%	21.3%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	68.5%	82.8%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	73.2%	77.0%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	84.5%	90.9%

TABLE 13

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYSCBOT WHEAT
DECEMBER EXPIRATION

	LOW DAY: OCT 3	HIGH DAY: OCT 4
TOTAL VOLUME	9,707	20,183
(all expirations)		
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	69	88
NUMBER BROKER TRADERS	19	24
BROKER TRADERS/TOTAL TRDRS	27.5%	27.3%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	65.1%	67.6%
VOLUME PER TRADER	256.9	447.4
TRADES PER TRADER	62.1	91.8
VOLUME PER TRADE	4.1	4.9
CT11 TRADES/ALLTRADES	27.3%	25.2%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	91.6%	92.3%
B-T CT11 VOLUME/ALL B-T VOLUME	28.7%	28.1%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	38.6%	42.8%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	55.2%	91.2%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	80.8%	74.6%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	96.1%	89.1%

TABLE 14

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYS

CBOT SILVER
DECEMBER EXPIRATION

LOW DAY: OCT 4

HIGH DAY: OCT 7

TOTAL VOLUME (all expirations)	558	3,155
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	11	13
NUMBER BROKER TRADERS	1	5
BROKER TRADERS/TOTAL TRDRS	9.1%	38.5%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	4.9%	81.4%
VOLUME PER TRADER	23	507.5
TRADES PER TRADER	8	37
VOLUME PER TRADE	2.9	13.7
CT11 TRADES/ALL TRADES	82.4%	37.3%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	1.4%	92.8%
B-T CT11 VOLUME/ALL B-T VOLUME	54.3%	29.1%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	6.4%	70.9%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	n.a.	41.6%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	12.3%	94.8%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	0.3%	91.8%

broker trader were also much higher on the high volume day. The ratio of broker trader CTI1 volume to volume executed by broker traders for customers was much smaller on the high volume day. Broker traders' share of all CTI2, CTI3 and CTI4 volume was also much higher on the high volume day.

MACE. Tables 15, 16 and 17 show several measures of broker trader activity for nearby months on the low and high volume day for MACE T-bond, wheat, and D-mark futures.

T-bond volume was lowest on October 6 and highest on October 7 (Table 15). There were 40% more traders trading T-bonds on the high volume day and 57% more broker traders on that day than on the low volume day. The volume and number of trades per broker trader were much higher on the high volume day, but broker traders executed a nearly identical proportion of all volume on both days. On both days broker traders executed around one-third as many trades for their own accounts as they did for other customers. Except for the increase in CTI2 volume on the high volume day, broker traders executed similar proportions of all customer volume on the two days.

Wheat volume was lowest on October 3 and highest on October 5 (Table 16). While the number of all traders and broker traders was lower on the high volume day, broker traders' share of all volume on the high volume day was nearly double that of the low volume day. Again, this occurred as broker traders executed more trades and larger trades. While broker traders' CTI1 volume as a fraction of all broker trader volume was lower on the high volume day, their share of all CTI1 volume was higher. Brokers traders executed a smaller proportion of all brokerage volume on the high volume day.

Volume in the MACE D-mark contract on the high volume day was more than ten times that of the low volume day (Table 17). The total number of traders and number of broker traders on the high volume day increased by four and three, respectively, from the low volume day. The share of all volume executed by broker traders rose from 14.4 to 27.0% across these days. Volume and trades per broker trader were much higher on the high volume day. On the high volume day the proportion of CTI2 and CTI3 trades that were executed by broker traders increased substantially. However, CTI4 executions by broker traders declined. The ratio of broker trader CTI1 volume to all volume executed by broker traders increased from 17.4 to 62.7%. Broker traders executed a larger share of CTI1 volume on the high volume day.

CRCE. Table 18 shows various measures of broker trader activity in the nearby month of the CRCE Rough Rice contract. No broker traders were active on either the high or low volume day.

Conclusions

We have presented our preliminary observations on broker trader activity and liquidity. None of our findings are conclusive and

TABLE 15

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYSMACE T-BONDS
DECEMBER EXPIRATION

	LOW DAY: OCT 6	HIGH DAY: OCT 7
TOTAL VOLUME (all expirations)	2,695	7,759
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	156	219
NUMBER BROKER TRADERS	14	22
BROKER TRADERS/TOTAL TRDRS	9.0%	10.0%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	37.3%	38.4%
VOLUME PER TRADER	70.6	134.2
TRADES PER TRADER	25.2	34.52
VOLUME PER TRADE	2.8	3.89
CT11 TRADES/ALLTRADES	23.9%	26.0%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	80.5%	80.8%
B-T CT11 VOLUME/ALL B-T VOLUME	14.4%	19.5%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	9.2%	12.1%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	60.7%	75.5%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	76.3%	79.2%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	84.7%	84.5%

TABLE 16

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYS

MACE WHEAT

DECEMBER EXPIRATION

LOW DAY: OCT 3

HIGH DAY: OCT

TOTAL VOLUME (all expirations)	387	1,263
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	26	22
NUMBER BROKER TRADERS	3	2
BROKER TRADERS/TOTAL TRDRS	11.5%	9.1%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	16.7%	30.6%
VOLUME PER TRADER	20.2	180.2
TRADES PER TRADER	11.5	61.5
VOLUME PER TRADE	1.8	5.9
CT11 TRADES/ALL TRADES	23.2%	23.6%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	84.1%	61.4%
B-T CT11 VOLUME/ALL B-T VOLUME	17.4%	11.8%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	3.7%	7.3%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	0.0%	0.0%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	50.0%	2.1%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	95.9%	72.4%

TABLE 17

COMPARISON OF BROKER TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYS

MACE DEUTSCHE MARKS
DECEMBER EXPIRATION

	LOW DAY: OCT 7	HIGH DAY: OCT 5
TOTAL VOLUME	80	914
(all expirations)		
DECEMBER CONTRACT ONLY:		
TOTAL TRADERS	19	23
NUMBER BROKER TRADERS	1	4
BROKER TRADERS/TOTAL TRDRS	5.3%	17.4%
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	14.4%	27.0%
VOLUME PER TRADER	11.5	61.6
TRADES PER TRADER	11.5	19.1
VOLUME PER TRADE	1	3.2
CT11 TRADES/ALLTRADES	17.4%	52.9%
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	28.4%	21.7%
B-T CT11 VOLUME/ALL B-T VOLUME	17.4%	62.7%
B-T CT11 VOLUME/TOTAL CT11 VOLUME	4.3%	31.5%
B-T CT12 VOLUME/TOTAL CT12 VOLUME	0.0%	44.4%
B-T CT13 VOLUME/TOTAL CT13 VOLUME	33.3%	50.0%
B-T CT14 VOLUME/TOTAL CT14 VOLUME	42.5%	7.3%

TABLE 18

COMPARISON OF BROKER-TRADER ACTIVITY ON HIGHEST
AND LOWEST VOLUME DAYS

CRCE ROUGH RICE
NOVEMBER EXPIRATION

	LOW DAY: OCT 6	HIGH DAY: OCT 7
TOTAL VOLUME	11	145
(all expirations)		
NOVEMBER CONTRACT ONLY:		
TOTAL TRADERS	5	7
NUMBER BROKER TRADERS	0	0
BROKER TRADERS/TOTAL TRDRS	n.a.	n.a.
BROKERS TRADERS ONLY:		
% OF ALL VOLUME	n.a.	n.a.
VOLUME PER TRADER	n.a.	n.a.
TRADES PER TRADER	n.a.	n.a.
VOLUME PER TRADE	n.a.	n.a.
CT11 TRADES/ALL TRADES	n.a.	n.a.
B-T CT12,3,4 TRADES/ALL CT12,3,4 TRADE	n.a.	n.a.
B-T CT11 VOLUME/ALL B-T VOLUME	n.a.	n.a.
B-T CT11 VOLUME/TOTAL CT11 VOLUME	n.a.	n.a.
B-T CT12 VOLUME/TOTAL CT12 VOLUME	n.a.	n.a.
B-T CT13 VOLUME/TOTAL CT13 VOLUME	n.a.	n.a.
B-T CT14 VOLUME/TOTAL CT14 VOLUME	n.a.	n.a.

much more research is needed for a definitive picture of the complex relationships between broker trader activity and market liquidity. Nevertheless, our preliminary work leads to several tentative conclusions as follows:

- a. Broker traders account for a major if not the major share of futures market activity.
- b. The broker traders provide a substantial amount of the speculative capital on the floor of the exchanges. This is true in almost all nearby expirations.
- c. Some variation in broker trader activity is seen across markets based on their underlying commodity. Broker trader activity is greatest in the agricultural contracts and slightly less in the interest rate complex.
- d. Broker traders make a substantial contribution to market liquidity in low volume periods as they increase their own trading during periods of slack brokerage demand.
- e. Broker traders are a major force supplying back month brokerage and liquidity in markets with volatile spread relationships.
- f. Dramatic variations in volume and demand for brokerage are observed across commodity and through time. This is associated with a large but widely varying amount of broker trading.

In general, the broker trader plays a critical role in contract activity across all three exchanges. A role that will be fully understood only with further research.

Appendix C

-C1-

CARGILL

1000 La Salle Street Bldg.
125 South La Salle Street
Chicago, Illinois 60603

February 6, 1989

TO: KARSTEN MAHLMANN
CHAIRMAN OF THE BOARD
CHICAGO BOARD OF TRADE

FROM: PETER VON ESCHEN
FUTURES FLOOR MANAGER
CARGILL, INCORPORATED

SUBJECT: DUAL TRADING

Dear Cash:

The broker/trader has provided the users of the Commodity Markets with better executions at lower cost for many years. Therefore, we believe that to discard dual trading would adversely affect the efficiency of the marketplace.

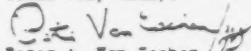
Perhaps the classification of each broker as a "broker" or "broker/trader" would be a reasonable compromise. It would enable each clearing firm to use this information in the selection of the brokers it wished to use.

This issue is of such importance to both members and customers that it deserves to be determined by the measured response as advocated at last Tuesday's floor meeting.

Finally, to outlaw dual trading before any charges have been made, even before the investigation is admitted by the authorities, might convey to the watching public a sense of guilt by the Chicago Board of Trade. That would indeed be unfortunate for all of us.

Furthermore, we feel that this exchange has regulations in place today that if enforced rigorously, can guard against any potential abuses of dual trading.

Yours very truly,



Peter A. Von Eschen
Manager - Floor Operations
Cargill, Incorporated

PW/dcb

-C2-

Barnes & Co.

MEMBERS OF ALL PRINCIPAL FUTURES EXCHANGES

February 6, 1989

Mr. Karsten Mahlzann
 Chairman, Chicago Board of Trade
 141 West Jackson Blvd.
 Chicago, Illinois 60604

Dear Mr. Chairman:

The undersigned would like to express our strong opposition to proposed changes in dual trading. We believe that our clients benefit greatly from the flexibility that dual trading offers. We are particularly concerned that we will not be able to "leg" spreads, and that with brokers not being able to keep the spreads in line the difference between the bid and ask will grow to the detriment of all who use the Board of Trade for risk transfer. We also believe that volume over all will drop by over 10 percent.

The Board of Directors handling of these matters appears to be inconsistent at best. On one hand the Board of Directors refuses to answer allegations in the press - on the other hand they propose to change an age old practice specifically because of these allegations. It appears to us that dual trading is being offered as a sacrificial lamb to appease Congress and others.

The main argument against dual trading appears to be that the temptation is too great to steal. In that case the banks should get rid of all bank tellers because of the temptation.

As a self-regulatory body we must do the job stringently, and weed out the bad apples ourselves. If we now try to placate, and ban dual trading, it is tantamount to admitting that we can't handle the job ourselves - and that the practice has led to widespread abuse all along.

-C3-

Page 2 of 2
Mr. Mahlmann

As a group with years of experience in several pits we do not believe that dual trading has lead to widespread abuse. On the contrary our clients are proud of our integrity, and we are proud of the integrity of our fellow members.

Yours truly,

John N. Macintosh

John N. Macintosh

Dale E. Lorenzen

Dale E. Lorenzen

S. Hal Phillips

S. Hal Phillips

Matthew J. Connolly

Matthew J. Connolly

Thomas S. Law

Thomas S. Law

-C4-

1701 N. Moran Park, #2
Chicago, Illinois 60614
February 6, 1989

Mr. Tom Donovan
President
The Chicago Board of Trade
141 W. Jackson Blvd.
Chicago, IL 60604

Dear Mr. Donovan:

I am a local trader and owner of a full membership at the board of Trade. I do not fill customer orders in the pits, but I do handle customer orders, from commercial firms, for commissions (off-floor).

I speak for myself and for my customers in stating that it is a mistake and a disservice to customers to ban dual trading.

To put the argument simply, if dual trading is banned, no broker will dare take the financial risk to execute a spread order by "legging" the order, i.e. by buying on month's futures contract outright in the market, and selling another outright in the market.

This will force brokers to rely strictly on local traders for spread quotes and spread execution, or to depend on another broker fortuitously having the opposing spread to execute on another order. The good brokers know how to judge whether a local's offer is on the market, and if they judge that it is not, they can go into the market with outright trading ("legging"), actually competing with the local instead of depending on him, to complete the order.

Unfortunately, it is difficult for the average person to understand this subtlety. But eliminating dual trading will also eliminate a source of competition for the locals that makes the market more honest and increases liquidity.

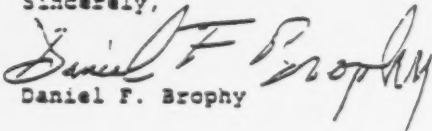
I heard a worthwhile suggestion to alleviate customers' doubts about dual trading. All brokers who trade for themselves should register the fact with the exchange and with every clearing firm with whom they do business. The clearing firms should notify customers that these brokers intend to trade for themselves, and

~~CS~~

Page 2
Mr. Tom Donovan
Chicago, Illinois
February 6, 1989

give the customers the option to direct their orders to other brokers. Also, the exchange should regularly and randomly audit brokers via the CTR system and any other methods available.

Sincerely,


Daniel F. Brophy

-6-

SOUTHERN FARMERS ASSOCIATION

324 North Palm Street

North Little Rock, Arkansas 72110

March 15, 1955

Karsten Marlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 20th Floor
Chicago, IL 60604

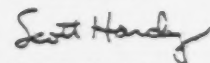
Dear Mr. Marlmann:

The success of any business depends on its credibility. I understand that any abuses of trading rules must be detected and eliminated at the Chicago Board of Trade and other futures markets. However, these abuses, if they occur, need to be corrected in a manner that does not reduce the flexibility of trading that we currently experience.

I understand that there has been a move to eliminate dual trading for pit traders. I understand, as an agent for a commercial feed and grain operation, that taking away this ability from traders will decrease my flexibility, increase my cost and lower the overall liquidity of the market.

I want my broker to have all the tools necessary to execute my orders swiftly and efficiently. I would appreciate you letting my feelings on this matter be known to those making policy for the industry.

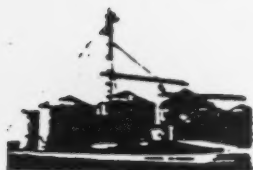
Sincerely,



Scott Hardy
Southern Farmers Association

-7-

CENTRAL LOUISIANA GRAIN CO-OP. INC.
P.O. BOX 748
BOYCE, LOUISIANA 71409



March 15, 1969

Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann:

Due to the recent trading abuses at the Chicago Board of Trade I urge you to consider the following two points.

1. The need to try to detect and eliminate trading abuses at the Board of Trade as quickly as possible, and
2. Urge that they do not give up the dual trading ability of the traders in the pit.

I appreciate your support.

Sincerely,

John P. O'Neill, Jr.
Manager.

-CB-

Danny J. Brown

TREASURER/GENERAL MANAGER
 WOODY FARM SERVICE CENTER, INC.
 DAVISBORO, GEORGIA

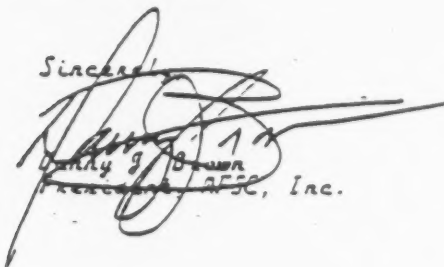
3-13-1989

Mr. Karster Mahlmann, Chairman
 Chicago Board of Trade
 141 W. Jackson St.
 6th Floor
 Chicago, IL 60604

Dear Mr. Mahlmann:

In the recent months a growing concern has arisen from the reported trading abuses at the Chicago Board of Trade. We urge you to try to detect and eliminate these trading abuses, but not at the expense of giving up the ability of dual trading by the floor traders. We feel that the service provided to the grain industry via dual trading is an asset to us and that some other form of restraints should be implemented to stop the trading abuses.

Sincerely,



Danny J. Brown
 Treasurer, WFS, Inc.

0981

BARLEY
OATSWHEAT
SOYBEANSPhone
734-4764103

C. E. McSWAIN & SONS, INC.

Route 1, Box 157
Norwood, N. J. 07061

March 16, 1989

Karsten Mahlmann
Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann,

It has recently come to my attention that the government, in its investigation of the CBOT concerning trading abuses, is considering elimination of dual trading pit brokers. I strongly support the need to detect and stop trading abuse at the CBOT as soon as possible. However, the ability for pit brokers to engage in dual trading is an extremely efficient mechanism for executing spread orders. We as country elevators use the spreads to set the market structure for our merchandising programs.

I urge you to use any influence that you have in behalf of the dual trading issue.

Sincerely,

Tim Lovry, Merchandiser
C.E. McSwain & Sons, Inc.

-C10-

FARMERS MILL AND ELEVATOR CO., INC.
DEXTER SUPPLY COMPANY

P. O. BOX 86 - PHONE 912-875-3107

DEXTER, GEORGIA 31019

Established 1952

"Service and Supply in Agriculture"

S. E. DAILY
-HAROLD DAILY-

March 14, 1989

Karsten Manlmann
 Chairman
 Chicago Board of Trade
 141 W. Jackson, 6 th Floor
 Chicago, IL 60604

RE: DUAL TRADING

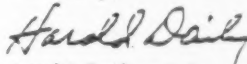
Dear Mr. Manlmann:

It has come to our attention that the government is trying to eliminate dual trading on the CBOT. We have read the reports of abuse by some and feel that those who fall into this category should be weeded out. It is our theory that in a democratic society such as ours that the major should not have to suffer for the actions of a few.

We are engaged in an agri-business, which includes not only the supply of agriculture needs but also provides a market for their crops. Therefore, grain trading, hedging and contracting by means of orders to sell placed with our broker are a vital part of our business. Anything that may interfere with the freedom to efficiently handle these type transactions could very broad effects on the trade industry as a whole.

In a nut shell, we support the effort to find and eliminate abuses on the CBOT, but we strongly uphold the dual trading ability of traders in the pit.

Sincerely,



Harold Daily, V.P.
 and General Manager

HJD:cjr

-C1-

3/19/89

HARSTEN PAULMANN
CHICAGO BOARD OF TRADE
141 W. JACKSON 6 FLOOR
CHICAGO, ILL. 60604

MR. PAULMANN,

I DO NOT HAVE A PROBLEM WITH BROKERS BEING ABLE TO DEAL TRADE.

IN MY OPINION A BROKER BEING ABLE TO TRADE ON HIS BEHALF AND
MINE INCREASES LIQUIDITY AND REDUCES VOLATILITY.

WE WILL NEVER PREVENT A CROOK FROM ENTERING ANY ASPECT OF BUSINESS
THEY MANAGE TO GET INTO PRIVATE AND PUBLIC BUSINESS AS WELL AS WE
CAN ATTEST TO.

THE IMPORTANT THING IS THE SYSTEM WORKS AND A PERSON WHO DOES
NOT OPERATE WITHIN THE SYSTEM DOES NOT LAST.

SINCERELY,

Ernie J. Peterson

ERNIE PETERSON
C.F.S.
BOX 24
DASHTON, WI 54619

-43-

LAWNDALE GRAIN, INC.

PHONE (312) 732-7356
LAWNDALE, ILLINOIS 61751

March 13, 1989

Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann,

We support your efforts in the need to try to detect and eliminate trading abuses at the Board of Trade as quickly as possible, and We urge that they do not give up the dual trading ability of the traders in the pit.

Respectfully yours,

James E. Bell, Mgr.
Lawndale Grain, Inc.

-C14-

ROCHE MANUFACTURING CO

SPREADER
SERVICEHIGH GRADE  FERTILIZERS

NITR

Phone (912) 854-2206
411 EAST COURT STREET
WRIGHTSVILLE, GEORGIA 31096

March 13, 1989

Mr. Karsten Mahlmann, Chairman
Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

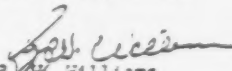
Dear Mr. Mahlmann:

We urge you to delete and eliminate trading abuses at the Chicago Board of Trade.

We also urge you not to give up the dual trading ability of the traders in the pit.

This could have a great impact on our business here in Georgia.

Yours very truly,


R.W. Williams
V.P. and Manager

RW:nl

-CL5-

February 8, 1989

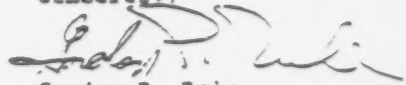
Gordon P. Rule Brokerage Co., Inc.
832 Judson Manor
St Louis, Mo. 63141

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board Of Trade
Chicago, Ill. 60604

I am a cash grain broker and occasional futures speculator who would like to comment on the proposal to ban dual trading. I believe the proposal would hamper liquidity and raise transaction costs. These negative effects would in turn hinder my own business since cash grain business volume hinges on all parts of the marketing process working efficiently.

I would advocate to maintain the present system which has been satisfactory to both myself and my customers.

Sincerely,


Gordon P. Rule

⁰¹⁶⁻
Drexel Burnham Lambert

Drexel Burnham Lambert Incorporated
3495 Piedmont Road
11 Piedmont Center
Atlanta, GA 30305-1738
404 231-1411

February 8, 1989

Mr. Karsten Mahlmann
Chairman of the Board
Chicago Board of Trade
141 West Jackson Boulevard
Chicago, IL 60604

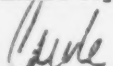
Dear Cash:

I fervently hope the Chicago Board of Trade will not seek or be coerced into eliminating "dual trading" as a membership right. The consequences in terms of lost liquidity alone would be disastrous, not to mention the obvious infringement upon rights of membership, to trade as well as to regulate itself.

While this suggestion has no doubt already been made, I would like to propose that the Board consider the merits of a practice Jerry Manne used many years ago when he was in a position to execute orders both for customers and for himself: that a member clear his own trades through a different house than that which handles his customer business. It is simple and reliable, like most of the practices which have made the futures industry unique in the financial investment world.

Again, my very best to you in your leadership. You have certainly happened in on interesting, and perhaps history-making, times, and the Board and the futures markets in general will, I believe, be the beneficiaries of your presence.

Kindest regards,


Carole S. Jacobsen
CSJ/sec

-017)



BENSON-QUINN CO.

1075 Green Exchange
Milwaukee, Wis. 53202

February 7, 1989

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

This letter is to express opposition to the proposed changes dual trading. Our company uses the CBOT to hedge risk in its cash grain trading operation. Market liquidity and volatility are constant factors in our risk management. Other factors in our risk management are honesty and integrity in our brokers. I hope the CBOT does not confuse the two issues and deprive me as a principle of the one item that I can make decisions about, i.e. honesty and integrity; and deny me the issues about which I have no control, i.e. liquidity and volatility.

Dual trading has, if properly surveyed, enhanced volume and price execution of orders. We hope that the CBOT is not so intense on giving the media something of a regulatory nature that they act in a irresponsible fashion in protecting the cornerstones of the market, its members, and its customers.

Sincerely,

BENSON-QUINN COMPANY

[Signature]
L.M. Neumann
Vice Chairman & COO

-C18-

February 3, 1939

E. Davison Massey
133 Chestnut Street
Winnetka, Ill. 50093

Mr. Karsten Mahlmann
Chairman
Chicago Board of Trade
141 W. Jackson Blvd.
Chicago, Illinois 60604

Dear Mahlmann:

I have read with interest over the past two weeks the very shrill newspaper coverage of the federal investigation of alleged improper trade practices at the Chicago Board of Trade. The various articles, particularly those of the Chicago Tribune unfortunately read as a indictment of not only the membership of the Board of Trade as a whole but the futures markets in general. These allegations and innuendoes belie the long history of service which futures markets have provided for agriculture and other sectors of the U.S. economy. It is inconceivable to think that the possibility of wrongdoing on the part of a few people implies a condemnation of an entire industry and its members.

Aside from the intensity of the trial by press I am extremely concerned about the possibility of such rule changes as the prohibition of dual trading. This little understood practice promotes healthy competition in the market and allows brokers the flexibility of obtaining the best execution of orders entering the market. Prohibiting dual trading would likely result in less competition, the reduced quality of execution and higher brokerage rates. The Board of Trade has functioned efficiently and faithfully for many more than 100 years and therefore to change the rules as a result of what seems to be a newspaper campaign on the part of an ambitious politician in the person of the federal prosecutor would not be keeping faith with the industry or the public which the markets serve.

Sincerely,



E. Davison Massey



-C19-

HIGHWAY #1 NORTH
POST OFFICE BOX 381
FAIRFIELD, IOWA 52556

FEB 19 1988
FAX 515-723-2222
WATS 800-423-4222
TELEPHONE 515-723-1122

FEBRUARY 1988

Mr. Karsten Manimann
Chairman, Chicago Board of Trade
141 W. Jackson
Chicago Illinois, 60604

Dear Mr. Manimann,

It is with great interest that we small country elevator operations in Iowa watch the current trading investigations into alleged trade abuses at the Board of Trade. We demand strict censure of any criminal acts that can be substantiated proven, but would be extremely concerned if any changes in current practice be implemented to "kill" the order system we now have. After converting well over \$100 million of Iowa producer grain using a hedge program the past 10 years, I'd have to say we have a great deal of confidence and reliance in the current system. It is rare when we question a "fill," and usually, it is in a very fast market, or otherwise understandable. I also believe that dual trading must never be banned, as loss of bid or ask and spread activity would be lost, and therefore certainly, raises the cost of the transaction to my customer.

Thank you for listening to my concerns:- I can be of any further assistance please do not hesitate to call at the numbers above.

Sincerely yours,

David S. Reiff, Pres.
Reiff Grain & Feed, Inc.
OSR:12

-220-

12-13-1959 11:12 AM TELETYPE UNIT 1000-1000 11:12 AM 1000-1000



MITSUBISHI INTERNATIONAL CORPORATION

CABLE ADDRESS:
MITSUBISHI NEWYORK225 MADISON AVENUE
NEW YORK, N.Y. 10022TELEPHONE:
212-609-2000

DATE February 18, 1959

OUR REF No

Mr. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

We, at Mitsubishi, would like to express our opposition to the proposed changes regarding dual trading. If it is the intent of the Board of Directors to root out stealing in the pits, then doing away with dual trading will not achieve that goal.

We believe that it is the customer that will suffer if dual trading is done away with. Firstly, the quality of the executions will deteriorate, especially with spreads. The fact that brokers will not be able to lag spreads will result in spreads being thrown out of line and the difference between the bid and ask will grow. The spreads will become distorted and will certainly hurt those who use the Board of Trade. Secondly, this proposed change will cause good brokers to either leave the pits altogether or limit their trading to their own account. Therefore, there will be a shortage of good brokers handling customer orders. Thirdly, the shortage of brokers will increase the cost of doing business in the pits and as a result, the customer's cost will also rise.

Therefore, we do not believe that dual trading has led to widespread cheating. We do believe that our brokers are of the highest integrity.

Yours truly,
Mitsubishi International Corporation

Tomio Goto
Tomio Goto, Manager, Soy Complex
Foods "A" Division

-C21-

FEB - 7 - 69 TUE 17:33 2700000000

DES MOINES GRAIN CO. -

FEB 08 1969

Tim Asper
Jay R. Eliason

Coast Grain Merchants
5731 URBANDALE AVE., SUITE #10
DES MOINES, IOWA 50310

Can E. Schumacher
Agent - 402

MR. Karsten Mahlmann
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, Illinois 60604

Dear Mr. Chairman:

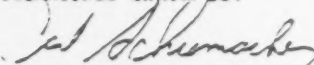
The owners of Des Moines Grain Co. would like to express our strong opposition to the proposed changes in dual trading. We believe the elimination of dual trading would reduce the liquidity of the market. We believe the cost of reduced liquidation to the market will far exceed any perceived loss from bucket trades or other problems highlighted during the investigation. We rely heavily on the CBOT for timely price transfer in our merchandising activities.

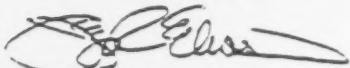
People, such as ourselves, who are not there to trade our own orders rely on the integrity of the brokerage firm we are using and have the ability to change firms if we feel our orders are not being handled properly. When we place a "market" order we understand the risks in placing that order. If we were unable to monitor activity on the screen we would rely on the broker we are paying the commission to perform that function.

Overall, we feel very strongly that the whole market should not be punished for what appears to be the actions of a relatively small percentage of the traders. There are many other areas of the political and business world that the same effort by the State's Attorney would generate more significant prosecutions.

We urge you to not act with haste when the significance of the problem has not been adequately identified.

Sincerely,
DES MOINES GRAIN CO.


Carl Schumacher, Chairman


Jay R. Eliason, President

-C22-

FEB 17 1939



COMMODITY TRADERS, INC.

7771 Mercy Road - Suite 211 - Omaha, Nebraska 68134-1400
Telephone: 402-391-3474

February 7, 1939

Mr. Karsten Maibach
Chairman, Chicago Board of Trade
141 West Jackson Blvd.
Chicago, IL 60604

Dear Mr. Chairman:

It has been brought to my attention that the directors of the Chicago Board of Trade could possibly stop the practice of mail trading.

I've been an active broker in the Midwest for the past twenty years trading commodity futures for country elevators, farmers and livestock producers.

I would like to express my opinion against the proposed change. Any change that would reduce liquidity or keep a broker from filling spread orders with the utmost speed and accuracy I would strongly oppose.

I agree that the temptation to cheat is always present where high amounts of money are involved. I do not feel 99% of the brokers dealing in an industry with well over a century of trading activity should be penalized by a few dishonest people.

Yours truly,

William J. Dostal

WJD:ne

-C21-

Refco, Inc.

389 Ridge Lake Boulevard
Suite 201
Memphis, Tennessee 38119Telephone
901 796-3310

February 1, 1989

REFCO'

VIA TELECOPIER 312-341-3392

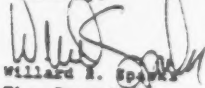
Mr. Karsten Muhlmann
Chairman
Chicago Board of Trade
LaSalle at Jackson
Chicago, IL 60604

Dear Mr. Muhlmann:

Re: Dual Trading

As a member of the Chicago Board of Trade and a user of the futures market, I encourage you to not act hastily in eliminating dual trading. I certainly believe there are some advantages in giving liquidity and movement within the market and I think we should do a detailed study and not be provoked into making a decision in the short run that might, in the long run, hurt the Board of Trade and the futures industry.

Sincerely,


 Willard H. Sparks
 Vice President

WHS:ptm

cc: Tom Grant
Thomas E. Dittmer

-C24-



QUINCY Soybean COMPANY
Producers of Quality Soybean Products

(217) 224-1800 • TELEX 40-4421 • 1900 GARDNER EXPRESSWAY • P.O. BOX 329 • QUINCY, ILLINOIS • 62306-0329

February 2, 1989

Mr. Karsten Mahlmann, Chairman of the Board
Mr. Thomas R. Donovan, President
Chicago Board of Trade
141 West Jackson Blvd.
Chicago, IL 60604

Dear Messrs. Mahlmann and Donovan:

Quincy Soybean Co. is a soybean processor and incidentally a member firm of the Chicago Board of Trade. We employ no representatives as traders on the floor of the exchange, but we execute trades through several commission houses for hedging purposes in our day to day activities.

We are very concerned about the action taken at the Chicago Mercantile Exchange to disallow "dual trading." We would hope that the Chicago Board of Trade leadership would give much more consideration and study before taking similar actions at the Board of Trade. Now is not the time for panicky reaction to public opinion and as yet unsubstantiated charges by the press and others.

There is no doubt that abuses do occur, but the system at the Chicago Board of Trade functions effectively. As a member firm who uses the exchange facilities extensively, we strongly admonish the exchange leadership to avoid premature actions that would result in more long term harm in trading effectiveness and liquidity.

Best regards,

QUINCY SOYBEAN CO.

J. Richard Holloway
Vice President of Marketing

JRG:22

Soybean Update

A Soybean Association publication for members

FEBRUARY 6, 1988

CLEAN: 100%

Market Struggles With Soy Supply Outlook

Near-term demand fundamentals may look good, but ample long-term supply prospects are limiting price movement, some analysts say. A sizable South American crop looming in the background, and talk of increased U.S. plantings this spring are holding futures in check.

However, other sources contend South American production isn't "in the bag" yet, and parts of the U.S. growing areas are critically short of subsoil moisture. They say markets will trade sensitive to world weather until stocks are rebuilt to comfortable levels.

Beans On Base Announcement Expected

Sign-up for the special provision to plant soybeans on permitted program base ended last Friday, and a USDA official tells *Update* a final announcement on the amount to be allowed could come as soon as mid-February.

If USDA reduces the amount producers signed up for, it will likely be by a straight factor. For example, if USDA says farmers may only plant 50 pct of their own sign-up percentage, a producer asking to plant 25 pct of his base to beans would only be allowed to plant 12.5 pct.

Soviet Purchase Maximum Bumped Up Again

Aggressive Soviet Union grain buys and a potential crop shortfall there encouraged USDA to bump up again the annual maximum purchases allowed from the U.S.

The original 12 min tonne agreement was raised to 16 min in December and has now been hiked to 20 min. Although soy purchases count toward the 9 min tonne annual maximum, they don't count toward the maximum.

Soviet Union Reenters U.S. Meal Market

Another 150,000 tonnes of U.S. soy meal were purchased by the Soviet Union recently, and some think more buys could be on the way.

However, given the track record of purchases and cancellations, sources are hesitant to second-guess Soviet needs. In addition, these shipments to the USSR have been sluggish.

Chicago Market Probe Stirrs Industry Talk

The probe into futures trading in Chicago is stirring both criticism and praise from industry contacts.

Last week, the Federal Bureau of Investigation's chief agent had been posing as traders in the soybean pit, among others, to uncover potential wrongdoings.

The inquiry centers on "bucket trading"—transactions which don't give investors (such as farmers) the probable price for their trades. Instead, a broker may take order at a couple of cents above or below what the market wants and pocket the rest.

Although it's too early to discuss any specific impact or possible impact on soybean futures trading, ASA's Vice-President Dennis Sharpe says the FBI's investigation perpetuates fear and distrust among market users.

"It's unfortunate. Farmers benefit greatly from CBoT's price discovery function. The futures market provides a way to lay off price risk," Sharpe says.

A study into 1984-85 soybean futures price movement conducted by ASA surfaced some unethical practices, but Sharpe says on balance the findings were positive.

Soybean farmer Ken Calenberg, a member of the Board's Ag Advisory Council, says, "We need to clean up the problem and maintain integrity. Producers can't expect to get 100 pct of every market order they place. But if the system is abused, there's discipline in place."

Floor sources note trading volume has dropped since the investigation was made public, but it can't be solely blamed for the drop in volume. A lack of fresh fundamental news has also subdued trading interest.

Supplies Tighten On Strong Bean Exports

Small pockets of tight soybean supplies are growing into larger areas of pinched availability. Slack producer sales and increased export interest last week combined to firm Gulf soybean values. Export inspections hit a 1988-89 marketing year high last Monday, and another dynamic showing is expected again this week.

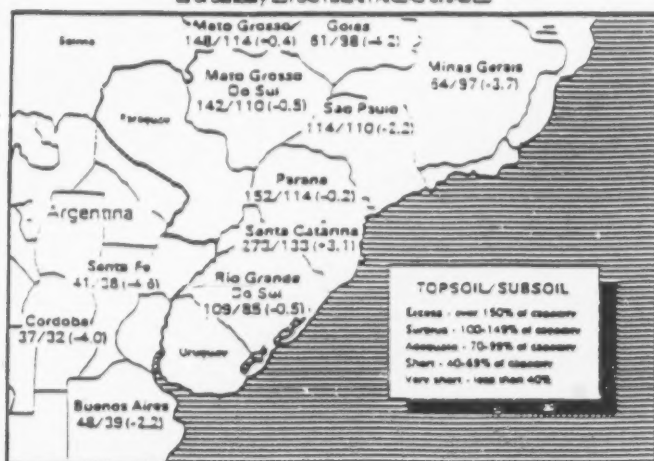
"Farmers are still not willing sellers at these price levels. Most producers want to see \$8.00/bu. cash beans again," says one operator manager in the Midwest.

The higher export inspections figure comes on the heels of the record soybean price drop in November.

In The Week Ahead...

- Reaction to Thursday's USDA Supply Demand Report
- Possible announcement of beans on base percentage
- Ongoing talk of potential South American crop size
- Likely increased feeding rates due to cold stress
- Growing attention to U.S. spring weather outlook

-C26- SOUTH AMERICAN SOIL MOISTURE as of January 23/ SOYBEAN AREAS SHADED



Departure in inches from normal

Courtesy of Global Weather Services

South American Supplies May Temper Stocks: Use Impact

As South American soybean production takes a growing share of the world market, analysts say the U.S. ending stocks to use ratio may begin to lose its influence on price direction.

"We have to look at world stocks to use ratio now. South America has capacity to offset what the U.S. does not have," says Shearson's Mickey Luth.

Because of the impact the South American crop has on the whole picture, some sources say it is more accurate to concentrate on quarterly stocks.

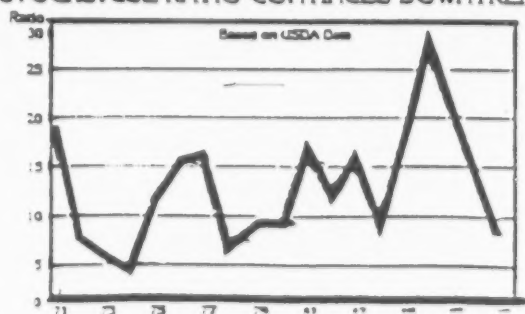
"History says Jan. 1 stocks were one of the nine highest in the last 35 years.

If you look ahead, however, and see South American production, then Mar. 1 isn't as tight," one adds.

Other analysts watching the ratio say historically, this year's figure is near the low end of the range. Using USDA's January ending stocks estimate of 140 million bushels and total usage of 170.1 million bushels, the ratio is 8.2.

"In the past, a ratio as low as 8.2 has called for prices to move higher to ration use and encourage production. A large South American crop just tempers the optimism to raise prices," says another industry contact.

STOCKS:USE RATIO CONTINUES DOWNTREND



Daily Rains Blanket

Rainfall has become a blessing for much of Brazil's growing season, which has been favorable.

"We've seen eight inches of average in southeast Brazil," says Freddie Woods, harvest manager.

Analysts and meteorologists say the ideal conditions may have encouraged some producers to plant beans than originally planned.

But as Brazil gets wetter, crops continue to just hold in some areas. Light showers have been enough to sustain plants and rebuild soil moisture levels.

Rain in most of Argentina last two weeks has been an average from 30-70 pct of normal.

Brazil Delays Oil Exports

Brazil may temporarily delay oil exports, as a price freeze on oil produce domestic oil prices.

A Brazilian government official said Update soyoil export restrictions probably be suspended in April to assure internal supply.

The popular brand name is no longer on supermarket shelves. Panic and buy up the oil.

This consumer panic buying what is causing soyoil supplies to appear limited, Brazilian analysts say.

In fact, many note the countries show enough soyoil to survive the crucial month of February.

Sources say typically constant oil shortfall this time of the year. The recent price freeze on soy oil heightened supply concerns.

Frigid Temps Alter Oil

The recent mercury plunge in the U.S. may freeze up marketing of oil, while meat feeding rates could get.

The drop from last week's blizzard temperatures has lent strength to complex, oil ideas processors. They want more beans and soy meal use may want more soybeans if cold weather.

The cold weather is catching up in soy meal, but it may also slow movement of grain," says U.S. America's C.H. Miller's Jerry C.

Meteorologists say extreme cold possible, following one of the worst in the history of the country.

Futures in Trading Range

Nearby beans appear to be in a trading range with a possible downward bias, technicians say.

Steeper's Pat Loocher estimates Mar could go to \$7.40/bu. or lower. There's a 50-50 chance we could take out Nov/Jan lows and still go lower," he notes.

On the upside, Tim Case of Timothy S. Case Commodities says Mar beans may go up to \$7.30.

He also anticipates a pull-down in Mar soybean prices first. He expects the downward move will take place by the last week of February or first week of March.

There's not a lot of room on the downside but it will be a good buying opportunity," he says.

Oil Stocks Sour EEP Talk

A glut of soyoil supplies is renewing ideas new offers of export bonus may be made.

Analysts say large supplies, as confirmed in the recent Census Bureau report, are an underlying factor to price depression.

"Aggressiveness is needed. The problem is we don't know who to give export bonus to," says Prudential-Bache's Dick Lowmy.

Several EEP recipients from the last marketing year still hold credits, including India. But a good oilseed crop in that country may mean fewer vegoil imports.

Cutting oil stocks through a slower crush pace is unlikely.

S&D To Show Few Changes

Few revisions to the supply/demand balance sheets are expected in Thursday's monthly report.

Many analysts are penciling in the same changes they anticipated USDA to make in the January report which never materialized.

Given the sluggish export pace and oncoming South American crop, analysts are guessing their export guess below USDA's 565 mln bushels by as much as 40 mln.

To offset lower exports, many also raised the crush estimate to be raised by a similar amount.

An acute clash-off between the two sides will determine the outcome.

NEWS & VIEWS

Soybean Association

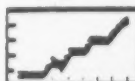
Threats...



Vegoil Imports On The Rise

Foreign vegetable oil supplies continue to flow into the U.S., ASA Staff V-P of Economics & Corporate Relations Dennis Sharpe says. The cut throat competition in the world export markets drove prices far below domestic U.S. prices, now flowing into the U.S. in significant quantities. USDA estimates soybean imports have escalated from zero in 1985/1986 to a projected 200 mln pounds for the 1988/89 marketing year.

Opportunities...



Poultry Growth May Boost Soybean Use

If broiler production steadily increases at its current rate, Senior Vice President of Pilgrim's Pride John Haid expects U.S. poultry production to increase by as much as 72 pct by the year 2000.

This growth translates into potential increased use of soybean meal in poultry feed rations. Haid says it takes 424,000 soybean acres to meet Pilgrim's soybean needs. All U.S. broiler and commercial egg producers consume 11.14 mln soybean acres, which is 20 pct of the U.S. bean crop. 72 pct increase could mean another 150 mln bushels of soybeans.

Meal Market Potential In USSR

ASA's first feeding trials in the Soviet Union were such a success that the Soviets would like to see additional trials conducted. But critical investments are needed to ensure the expansion goes to the U.S. ASA estimates that the U.S. could claim 300 mln bushels of the potential USSR soybean meal demand.

A Soviet newspaper printed trial results in an article which concluded soybean meal is truly a worthy universal protein supplement ingredient for all types of livestock and poultry.

Listening Sessions Successful

ASA's out listening to farmers. So far, ASA's Policies for the 1990s Task Force has conducted listening sessions in Minnesota, Mississippi, Texas, Tennessee, Kentucky, Louisiana, North Carolina, South Carolina and Georgia. The Task Force has 16 more sessions scheduled in February. The Task Force also surveyed more than 3,000 farmers for policy ideas.

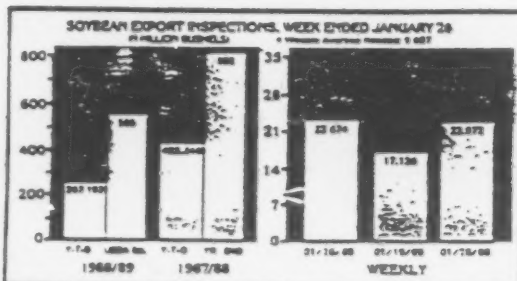
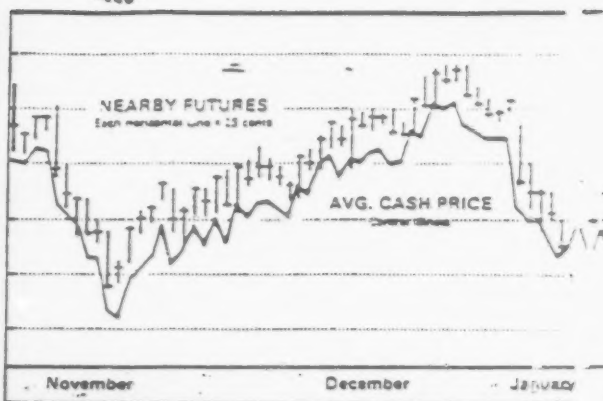
"The response from the country has been overwhelming," says Ed Hester, 1990s Task Force member from Benoit, Mississippi. "It has definitely been an educational experience. I have really opened my eyes to the concerns and ideas of other farmers in the different states."

During the listening sessions, randomly-selected farmers, both members and non-members, are asked to discuss four topic areas: environmental and ag chemical issues, export and trade issues, Third World and Latin American debt and domestic farm policy.

The Task Force wants to hear from you. It's developed a policy handbook and workbook for farmers to express ideas and concerns. If you haven't received a copy of the booklets, contact your state Soybean Association or call ASA at 800/USA-SOYA (in MO, 314/432-1600). Ask for extension.

SOY OUTLOOK

South American weather and demand will remain key market factors in the soy complex this week. The trade will become more and more responsive to crop estimates from both Brazil and Argentina. Strong demand for soybeans and soy meal should support healthy futures, especially if producer selling is needed to meet demand. Meanwhile, direction of deferred soybean futures will hinge on soybean planting ideas in the U.S. Thursday's USDA report may also dictate price movement by week's end. Cold temperatures should lend support to meat; but if the crush price picks up to meet meat demand, soyab prices will probably drag.

CASH SOYBEAN PRICES[illegible]NSPA Weekly
Crash Schedule

Wages Ending

01-25-88	18 963	06/88 Total	222 231
01-18-88	19 363	07/88 Total	231 138
01-27-88	26 774	USDA Estimate	1 040 000

on various sources

Technical Statistics

	Weekly	Cost	Remittance		Support	
Contract	Trans	1/31	Min.	Max.	Min.	Max.
Star Route	us	7.72	8.30	6.00	7.40	1.00
Star Mail	us	106.00	179.00	162.00	168.00	120.00
Star Oil	us	21.93	14.00	22.00	23.00	10.00

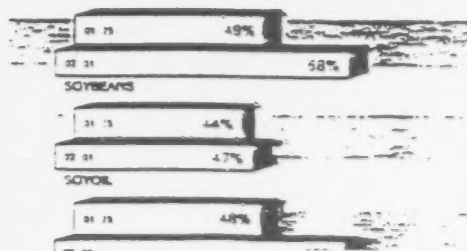
Comparative Study

	Current
U.S. Savings	180.00
Brac. Products	40.00
Arg. Products	25.00
Jan. Company	

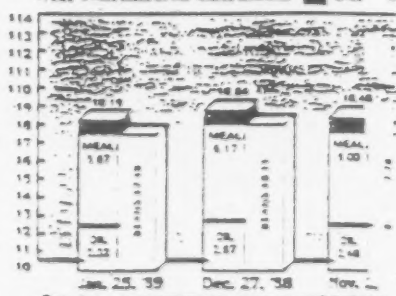
BULLISH CONSENSUS



Space Conversion is a measure of overflight and overland conversion. Over 75% indicates overflight, while 25% shows overland.



PRODUCT VALUE PER SOYBEAN ACRE

3/2000. (Please indicate on what features comments) ORCA



FARMERS COMMODITIES CORPORATION

HEADQUARTERS: MAILING ADDRESS: P.O. BOX 447, 225 MONROE, CHICAGO, ILL. 60666-0447
 312-333-5718 • CHICAGO: 312-333-5718 • NATIONAL: 800-347-1414 • TELETYPE: 312-333-5718

February 4, 1989

Mr. Tom Douvan
 President and Chief Executive Officer
 Chicago Board of Trade
 LaSalle at Jackson
 Chicago, Illinois 60604

Dear Tom:

I would like to commence this letter by commending you and your people on the position you have taken in this ordeal you are experiencing. I know there is tremendous pressure from the floor brokers to fight back and react to the challenge that has been presented to you by outside sources. Therefore, I believe that before you have all the facts and before you know what can be done constructively, you are doing the proper things.

My main concern, as president and C.E.O. of a clearing member, is somewhat different. I personally believe that dual trading, or brokers who trade for themselves and for companies such as ours, has far more value than no trading. Therefore, rather than prohibiting this from happening, I would like to recommend that it be monitored and controlled through a series of audit trails much as the clearing members are monitored and controlled by the exchange and other regulatory agencies. The integrity of the system could be maintained by having the brokers submit daily position reports, auditing brokers monthly, and notifying members as to those brokers who would not perform broker-trader functions. There should also be some control procedures in place to prohibit these brokers from exercising discretion about trades. The market needs the added liquidity that the broker-trader represents. Our firm selects the brokers who execute our trades and if the broker doesn't perform to our standards, we change brokers.

The monitoring system could be financed from a sur charge on the brokers' business on a per round basis so that there not be a new and additional cost to the exchange.

I hope that a constructive compromise can be achieved to continue provide adequate liquidity in the market and quality of brokers handling member business that the exchange will continue to have value to us as it has in the past.

I regret very much that a very small minority in the pit is presenting such a problem to all of us but recognize that this is not something new - that it is the history of any system.

Thank you for your kind attention. I wish you success in a quick solution to these problems.

Sincerely,

Harold I. Richard

Harold I. Richard
 President

FTR/pa

-C30-

FEB 26 1989 11:47 COTTON CAPITAL

P. 21

Mr. Karsten Mahlmann
 Chairman of the Board
 Chicago Board of Trade
 Chicago
 Illinois 60604

Commodity
 333 Via T...
 Chicago
 Illinois 60604

February 26

Dear Mr. Mahlmann,

I write to you with some comments on the proposal to ban "dual trading" on the CBOT.

I believe that such a move is unwarranted unless it can be shown that the existence of this system has led to abuses which cannot be controlled by other means. Outlawing dual trading would have the following negative effects.

1) Liquidity would be jeopardized. This would particularly apply to back month liquidity. Brokers would no longer be able to compete with locals in the execution of deferred spreads (they would be prohibited from taking market in "legging a spread"). The resultant less favorable executions would eventually lead to trading of deferred spreads and thus reduce open interest.

2) Transactions costs would increase. There would be a tendency for brokers to want to become locals. I believe that this would apply to the most active brokers in particular. This would either lead to less efficient execution by the second-tier brokers or a higher brokerage rate charged by the better brokers.

I have been trading cash grains or grain futures as a full time occupation since 1976. I have worked for two grain exporters (Continental Grain and Louis Dreyfus) and I am currently a CTA. I believe that dual trading enhances liquidity and promotes competitive transactions costs. Unless the CBOT is convinced that there are abuses stemming from dual trading that cannot be ameliorated in any other way, a banning of this activity should be avoided.

Yours Sincerely,

M. E. A. H. L.

Mark E. Hawkins

⁻³¹⁻
Bridgeport Securities Group

February 6, 1969

Dear Mr. Mahlmann:

I just want to drop you a line to let you know I feel that prohibition of dual trading will hurt liquidity, the public and the exchange.

Sincerely,

Patrick Girondi
Patrick Girondi

401 S. LaSalle
Suite 200
Chicago, IL 60605

-C32-

MAR 2



Deerfield-Farms

904 Rt. 224 • Deerfield, Ohio 44111 • (216) 584-47

March 17, 1989

Chicago Board of Trade
141 W. Jackson, 6th Floor
Chicago, IL 60604

Dear Mr. Mahlmann:

I have recently been made aware of some discussion within the CBOT organization pertaining to the ability of the floor brokers to trade Duality, for personal as well as customer accounts simultaneously.

Speaking from the perspective of industry (grain) and brokerage (formerly AP, current CTA), I don't think it would be beneficial to anyone to eliminate the ability of brokers to Dual trade. Liquidity is one thing that has made the CBOT efficient and a great market place for all concerns. Eliminating Dual trading may severely affect the kind of liquidity that has enabled the CBOT to serve commercial and public concerns with the quality that it is known for. This is not, in my opinion, an abuse of the marketplace.

I want to also compliment you for the good job in regulating the activities on the floor thus far and I'm sure that your decisions will insure an efficient, fair market place for years to come.

Sincerely,

Jeff Koenig
Grain Merchandiser, CTA

tr

cc White Commercial Corp.

-D1-

Appendix D

ALTERNATIVE MARKET MECHANISMS FOR LIQUIDITY

Broker trading greatly enhances the liquidity of futures markets. It minimizes the bid/ask spread and lowers transaction costs, helping to ensure that U.S. futures markets continue to dominate the world's futures industry. Broker trading restrictions would reduce this liquidity creating greater costs for all traders and handicapping the ability of U.S. markets to compete internationally. As discussed earlier, such restrictions pose clearly identifiable costs on the market for benefits that are only conjectural, at best.

The CFTC letter of March 8, 1989 suggested that other trading mechanisms may compensate for the liquidity lost with broker trading restrictions. Specifically, four trading mechanisms were suggested in the letter as substitutes for broker trading -- market makers, sunshine trading and large and small order trade execution procedures. In fact, these other mechanisms are not substitutes for broker trading for reasons discussed below.

Marketmakers

A marketmaking system creates a special category of floor participant with particular responsibility for ensuring an active market is maintained for a commodity. This responsibility usually requires that a two-way market be offered within a maximum price spread up to a maximum order size. In return for this responsibility, a set of structured incentives is put into place. These incentives are designed to compensate the marketmakers for the provision of liquidity services.

In the presence of broker trading, a marketmaker has an additional source of income; i.e., brokerage, to supplement the income generated from marketmaking. In the absence of broker trading, the income generated from marketmaking would have to be higher to induce a party to provide liquidity services. Given equivalent demand for marketmaking, with and without broker trading, increased income can only come from an enhanced incentive program. These financial incentives to provide additional liquidity services will raise the overall transaction costs in the market via new fees or franchised monopolies. Ironically, customers (commercial firms) will be paying a premium to obtain a service - liquidity - that was available under the broker trading regime at a lower cost. The additional incentives required to induce additional liquidity services under a segregated regime constitute a dead weight cost to society with no offsetting benefit. Furthermore, it is doubtful that in a rapidly moving market a single marketmaker could substitute for the liquidity provided by competitive multiple broker traders.

Since it is commercial firms who put value on liquidity services it should be their province to determine the most effective market structure for delivering those services. Under a broker trading regime commercial firms have the discretion to execute their orders through a broker who only fills orders or a broker who also

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trades for his own account. Obviously a firm will seek the individual who provides the best "fills" and a broker trader who consistently provides inferior service will lose business in the competitive environment. Thus, in the broker trading regime a level of market discipline exists that can only be created in a marketmaker system without broker trading by isolating market roles and forcing a higher cost.

Sunshine Trading

Sunshine trading is a trading practice which involves prearranged trading and thus is currently illegal at the Exchanges. Proponents of sunshine trading claim that its introduction would work to reduce the "liquidity costs" faced by commercials in their execution of orders on the floor. Scalpers would be compensated for the services they provide to the market, primarily the fact that they stand ready to either add or deplete their inventories in order to take the opposite side of orders entering the pit. The size of the bid/ask spread is a function of the compensation required to assume this role. Formally stated, scalpers set their bid/ask spread equal to their expected revenue from liquidity seeking traders minus their expected loss from informed traders.

Informed traders have proprietary information exclusive to them and take positions according to the insight they gain from it. These "informed traders" impose losses on scalpers who stand ready to take the other side of an "informed" trader's order but are not privy to his store of information. Thus, to protect themselves against these sorts of losses to "informed" traders, scalpers raise their bid/ask spread to compensate for losses on trades.

Sunshine trading would purportedly reduce the risk to scalpers of taking the opposite side of certain trades and hence reduce the premium on the bid/ask spread due to this precautionary behavior. The preannouncement of a trade is alleged to reduce uncertainty by indicating a trade is not based on exclusive information but on the individual's financial requirements or general market conditions. Therefore, the expected loss from lack of information should be zero. With the reduction of information risk, a scalper should be able to quote a smaller bid/ask spread without changing return expectations.

Sunshine trading is also designed to force the reduction of the bid/ask spread by increasing competition and volume. Knowledge of the coming trade is supposed to increase competition by attracting additional scalpers to the floor and commercials willing to place market orders on the opposite side of the market at the same time. Volume is to increase as scalpers establish inventories to offset against the pre-announced trade. The increased volume and competition are designed to enhance liquidity on the floor, narrowing the bid/ask spread.

In the short run sunshine trading would be expected to marginally increase commercial volume, but to lead to a reduction in speculative activity, especially scalping. The overall net effect on exchange activity would be a reduction in exchange volume

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because the increased commercial volume would not offset the reduction in speculative activity.

Over the long run the migration of scalpers from futures markets is inevitable in the face of these lower average returns. Scalpers, like any other economic agents, would seek out a higher return for their capital. In the face of lower returns, scalpers would leave the market until the point at which the constriction in liquidity services once again raises the return scalpers obtain back to a competitive level. Transactions costs would rise for all traders thus reducing the informational efficiency of futures markets.

As advocates for sunshine trading would probably admit, this trading mechanism is not designed to create a general increase in market liquidity. Instead, sunshine trading is designed to address only one type of trade, the supposedly informationless large trade that could arise in the context of program trading. The merits of sunshine trading aside, sunshine trading is not a substitute for broker trading and would not compensate for liquidity lost under broker trading restrictions.

Large Order Execution Systems

Large order execution systems, commonly known as "block trading" developed due to a perception of insufficient liquidity in security markets. Like sunshine trading, block trading involves prearrangement and is illegal at the Exchanges. The securities markets developed an alternative system for trading blocks rather than use specialist execution on the floor. Block trades are pre-arranged off the floor between a buyer and seller through a broker. All terms including price are set when the transaction is taken to the floor for its execution and de facto announcement. It is argued that pre-arrangement is necessary due to the lack of liquidity on the floor.

It should be noted that price effects from block trades have been identified. These effects occur after the trade rather than with the trade, therefore, reducing pricing efficiency in these markets. Temporary effects on price from seller-initiated transactions and permanent price effects from buyer-initiated transactions have been attributed to the demand for liquidity and to the emergence of new information.

It has been asserted that an economic need exists for block trading of futures contracts even with broker trading. The desire for such trading presumably originates from securities market participants.^{1/} Certainly a trade that is too large for execution in the current bid/ask spread could be readily envisioned. The

^{1/} Apparently, traditional market users such as grain companies, have found the current trading method adequate to meet their needs. This may reflect increased sophistication by traditional users or differences in cash market experiences.

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difficulty with such trading is readily apparent and is the basis for its illegality. With pre-arranged trades, information is not incorporated into the central marketplace in futures market via bids and offers on the floor in the execution of such trades. Instead, the price response is delayed with prices adjusting only after the trade is executed. The net effect of such trading is a less efficient pricing mechanism, the loss of price transparency and a reduction in the effectiveness of futures prices for price-basing and risk-shifting (since futures prices contain less information).

Block trading would enable the execution of large trades in a single fill. Some firms may find this desirable despite the fact that the single price may not be the best price for the order. Such a system would displace some of the liquidity lost via dual trading restrictions; however, its cost would be a loss of pricing efficiency for all market users and it would not address general liquidity needs for small and medium size orders.

Small Order Execution System

Most automated small order execution systems exist only in the context of a larger, non-automated auction market. These small order execution systems provide an auxiliary market function - the execution of small orders - and do not have the capacity to perform exchange functions on a stand alone basis. Small order execution systems use a market price - obtained in the larger, auction market - as a reference price with which to execute orders against the accounts of participating market makers. Small order systems are essentially passive systems - there is no capacity within the system to alter the price in response to change in the flow of (small) orders. The working assumption in the incorporation of any small order system is that the "economic weight" of such small orders will never be substantial enough to significantly affect the current market price, and that in the aggregate most small orders to buy are offset by small orders to sell. In essence, exchange officials have determined that the transactions cost of executing these small orders in the central auction marketplace will outweigh any minuscule effect on price these orders would have. Ultimately, all small order systems, whether automated or not, must be passive derivative systems that obtain the execution price for small orders from the main auction market.

The introduction of a small order execution system into a pre-existing auction market would not effectively change the amount of speculative capital required to maintain the same degree of liquidity in the pit. The level of capital necessary to support marketmaking activity would remain the same whether small orders are matched in the pit, or assigned passively through an automated execution system. What is crucial, however, is that a trader who agrees to match order on an execution system must have access to the trading pit to hedge the exposure of his accumulated positions. If traders were prohibited from simultaneously executing orders in the pit, there would be a significant increase in exposure and a consequent reduction in participation in the

-D5-

small order systems. The results would be a dramatic loss in liquidity for small orders, obviating the very reason for the introduction of a small order execution system in the first place. Small orders would then return to the floor with the incumbent dead weight loss in transactions costs from floor congestion imposed on all transactions.

Thus, these trading mechanisms are designed to address specific trade execution needs that have arisen in the context of the current broker trading system. These four mechanisms have developed in the securities markets. The liquidity in these markets, whether cash government securities or equities, comes primarily from upstairs trading between broker dealers: i.e., broker traders.

Moreover, it is important to recognize that two of these mechanisms -- sunshine trading and block trading -- are currently illegal in futures markets owing to the prearrangement of trading, which they require and the longstanding objection in futures markets against prearrangement as a source of abuses and reduced competition. If prearrangement of trades, and hence sunshine and block trading, were legalized in the interest of promoting liquidity, the upstairs broker traders would be the principal users of these mechanisms as they are in securities markets. Sunshine and block trading would be done to execute proprietary trades, customer trades or a combination of both. However, as this prearranged broker trading activity (sunshine trading and block trading) would be carried out upstairs rather than openly on the floor of the Exchanges, a more difficult surveillance challenge would be created. Instead of open broker trading in a pit, there would be "hidden" upstairs broker trading. The securities industry has not developed any surveillance structure for upstairs broker dealers (broker traders) comparable to the surveillance structure already in place for open broker trader dealings in futures exchanges.

In conclusion, none of these systems are designed to substitute for the liquidity of broker trading. In fact they are part of a securities market structure where broker trading is not only the key to liquidity but also hidden in an upstairs market that is far less regulated.



Chicago Board of Trade

June 1, 1989

Ms. Andrea Corcoran
Commodity Futures Trading Commission
2033 K Street, N.W.
Room 640
Washington, D.C. 20581

Dear Andrea:

Enclosed is a supplement to the empirical analysis of broker trading which was included as Appendix B in "Study of the Role of Broker Trading at the Chicago Board of Trade, MidAmerica Commodity Exchange and Chicago Rice and Cotton Exchange," submitted to the CFTC on May 1, 1989.

The supplement examines broker trading at the Exchanges over a longer time period than the earlier study (three weeks instead of one) and for more contracts (five additional CBOT contracts are examined in the supplement). Although this data sample is still extremely small, it is better and broader than the numbers based on only one week of data. Certainly more study is needed to determine whether differences in commodities or time periods or definitions of dual trading are important.

Please let me know if you have any questions.

Sincerely,

A handwritten signature in cursive script, appearing to read "T.C. Coleman".

Thomas C. Coleman
Vice President/Director
Economic Analysis and Planning

TCC/br

Enclosure

EXECUTIVE SUMMARY

This paper supplements the report on broker trading that the Exchanges submitted to the CFTC on May 1, 1989. It examines broker trader activity for a longer time period (three weeks instead of one) and for a total of twelve contracts (five more CBOT contracts than were examined in the original report).

This analysis reinforces our original conclusions that broker traders account for a large portion of all volume.

1. Broker traders represent a large share of all capital provided to the market:
 - broker traders account for approximately one-fourth of all CFTI volume, i.e., they provide approximately one-fourth of all the speculative capital present in the market.
2. Customers rely on broker traders to execute the majority of their trades:
 - broker traders execute approximately three-fourths of all customer volume in the more active contracts.

Activity of broker traders varies considerably from day to day, across commodities and across contract expiration months. The complexity of the issue and the tremendous variation in the prevalence of broker trading call for further research on the topic. The Exchanges are currently doing this.

The data demonstrates that broker traders enhance market liquidity and are relied upon to provide high quality execution of customer orders.

BROKER TRADERS AND MARKET LIQUIDITY

Supplement 1

Data Overview

The Chicago Board of Trade, the MidAmerica Commodity Exchange and the Chicago Rice and Cotton Exchange (the Exchanges) submitted a joint study on the role of broker trading to the Commodity Futures Trading Commission (CFTC) on May 1, 1989. In our report, we noted that time constraints had limited our analysis and additional analyses would be forthcoming. This supplement is the first of these analyses.

In our original analysis, we conducted an empirical investigation of broker trading activity in seven contracts based on data collected for one week in October 1988 (see Appendix B of our original submission). We were concerned that this small sample size created a bias in our findings; therefore, to reduce this bias the Exchanges have expanded this analysis to cover three weeks in the fourth quarter of 1988. In addition, the CBOT has added five additional contracts to provide a greater breadth of market types. Please note that despite this expansion of our analysis, the data set is still a potentially biased representation of the role of broker trading generally as the examined weeks were not chosen at random but rather were taken from a relatively short time period. Nevertheless, we believe

these data provide a more accurate picture of the role of broker trading in our markets.

The Exchanges are providing only an analysis of trading across entire sessions at this time. We shall continue to analyze broker trader activity in individual brackets and expirations over this expanded data set and provide the CFTC this analysis in the near future as well as the data upon which this analysis is based.

Data Overview

The Exchanges examined market activity for three 5-day periods in the fourth quarter of 1988 -- October 3 to October 7, October 10 to October 14 and November 14 to November 18. These periods were chosen because one week approximated the average fourth quarter volume for the three exchanges combined (10/3-10/7), one week was the low volume week for the quarter (10/10-10/14) and one week was the high volume week for the quarter (11/14-11/18).

The CBOT chose the following markets for examination:

- U.S. Treasury Bond Futures, Day Session
- Soybean Futures
- Corn Futures
- U.S. Treasury Note Futures, Day Session
- Wheat Futures
- MMI Index Futures
- 1,000 oz. Silver Futures
- 30-Day Interest Rate Futures

These contracts represent a variety of trading ranges including the highest volume contracts, a low volume contract (silver) and a new contract (30-Day interest rate). Furthermore, they provide

the ability to contrast activity in interest rate, agricultural and equity-based futures contracts.

For its analysis the MACE chose:

U.S. Treasury Bond Futures
Wheat Futures
Deutsche Mark Futures

These contracts represent high, average and low volume contracts at the MACE.

Finally, CRCE is submitting its one contract -- Rough Rice Futures. Table 1 shows the volume exhibited by each contract on the examined days, average volume for each contract and the weekly volume for all contracts combined.

Data Analysis

For each trading session, all traders were identified based on the CFTC's definition; that is, a trader was identified as a broker trader if he executed a CTI1 plus a CTI2, CTI3 or CTI4 trade during the session.^{1/} Based on this definition all traders were defined as broker traders or other traders and their activity across each trading session was examined.

^{1/} A CTI1 trade is a trade for one's own account, a CTI2 trade is for a clearing member's house account, a CTI3 is a trade for another member on the floor, or an account controlled by such other member and a CTI4 is a trade for any other type of customer.

TABLE I
VOLUMES OF EXAMINED CONTRACTS

DATE	10/03	10/04	10/05	10/06	10/07	10/10	10/11	10/12	10/13	10/14	11/14	11/15	11/16	11/17	11/18	AVE.
CBT																
T Bonds (Day)	255,000	103,100	313,943	104,612	450,763	69,303	185,929	245,987	292,797	309,826	190,654	277,235	433,340	418,647	242,442	273,357
Soybeans	39,046	42,770	36,125	49,412	46,182	36,466	30,973	20,640	51,066	36,860	55,045	52,390	37,708	61,539	40,039	43,227
Corn	34,667	46,333	45,997	50,018	40,687	27,783	32,663	29,657	41,504	26,110	47,139	41,009	43,587	70,008	32,933	40,681
T Notes (Day)	19,871	10,350	19,281	11,015	25,117	3,534	16,121	19,696	19,350	23,543	18,532	25,653	25,686	27,126	17,707	18,637
Wheat	9,707	20,103	12,212	19,602	16,751	12,412	18,454	10,865	14,507	12,508	18,152	13,951	15,257	20,891	9,792	18,003
MMI	3,806	2,679	2,181	1,732	5,349	3,191	5,786	6,530	4,863	4,726	5,018	3,865	7,224	5,021	4,283	4,429
1000oz Silver	2,076	558	810	1,532	3,155	4,641	1,207	1,232	915	1,414	4,077	3,618	7,159	1,306	3,480	2,476
30 Day	905	570	360	905	785	179	151	400	295	316	142	468	238	303	180	416
MACE																
T Bonds	4,269	3,017	4,720	2,695	7,759	3,106	4,334	4,732	9,974	10,010	3,938	3,475	6,359	5,965	3,383	6,104
Wheat	387	850	1,263	1,122	435	388	638	306	340	249	874	323	681	802	1,444	649
D-Mark	268	108	814	116	80	92	260	203	264	131	145	326	179	213	187	235
CRCE																
Rough Rice	24	99	26	11	145	126	321	229	266	284	63	97	180	223	84	146
Weekly Volume:	2,001,421					1,750,045					2,319,983					

Preliminary Analysis

Overview

An overview of the relationship of the broker trader to the market is provided by Table 2. This table shows the average of broker trader activity over all the examined trading sessions combined plus the maximum and minimum daily values for each variable.^{2/}

CBOT. For the most active CBOT contracts broker traders represented an average of 20% to 27% of the traders executing trades during a trading session. The T-Note and silver contracts stood at 14.8% and 16.1%, respectively. The highest concentration of broker traders was found in the wheat contract with 27.6% of the traders being broker traders. In contrast, broker traders constituted the smallest percentage of traders in the MMI (10.7%) and 30-Day interest rate (9.7%) futures contracts. In most contracts there was less than a 10 percentage point range between the maximum and minimum daily value. A larger variation was

^{2/} Daily values were weighted by the proportion of volume for all three weeks accounted for by a particular day in the calculation of these averages. These averages represent the ratio of broker trader activity to all trader activity for the three weeks.

TABLE 2
MARKET COMPOSITION OVER THE THREE EXAMINED WEEKS
Three-week Average
Maximum Daily Value/Minimum Daily Value

	VOLUME					
	%B-Ts/All			%B-Ts CT11/	%B-Ts CT11/	%B-Ts CT12.3.4/
	Traders	Trades	Volume	All B-Ts	All CT11	All 2.3.4
	Max/Min	Max/Min	Max/Min	Max/Min	Max/Min	Max/Min
CBOT						
T-Bonds	24.5	43.2	45.4	23.3	18.4	82.4
	25.8/21.8	51.2/39.1	50.4/40.5	26.0/21.2	25.2/15.0	88.7/63.2
Soybeans	20.9	42.1	41.2	26.4	18.3	73.8
	23.8/16.3	44.6/37.6	42.7/36.3	36.0/20.9	22.6/14.0	79.2/62.6
Corn	27.0	51.9	51.3	22.3	21.2	86.3
	30.3/22.2	54.3/48.6	52.9/48.2	33.4/17.7	27.7/17.4	93.3/76.5
T-Notes	14.8	35.5	39.1	13.7	15.8	68.5
	19.8/12.4	42.1/27.0	48.1/26.1	55.2/6.4	53.1/5.6	78.4/40.2
Wheat	27.6	62.9	61.0	29.0	36.6	84.4
	32.5/22.6	68.3/54.1	66.4/53.8	39.2/18.3	54.0/21.2	92.9/72.1
MMI	10.7	27.4	26.5	9.4	5.0	45.1
	14.4/6.9	34.6/18.4	37.0/16.7	23.3/3.9	10.6/1.8	63.7/27.7
Silver	16.1	28.7	28.5	21.7	12.4	42.4
	35.7/5.9	74.0/4.3	81.3/5.2	99.3/1.1	70.6/0.8	88.1/0.1
30-day	9.7	23.0	24.6	35.4	24.0	26.0
	20.0/0.0	37.7/0.0	41.8/0.0	92.6/0.0	80.0/0.0	53.1/0.0
MACE						
T-Bonds	7.8	30.0	37.4	19.0	11.6	79.0
	10.0/5.6	35.3/21.3	44.2/30.5	30.6/12.7	22.0/7.4	88.2/56.7
Wheat	8.5	37.3	23.4	17.2	6.6	45.4
	11.1/3.3	49.6/6.4	40.6/4.8	70.8/3.4	19.6/0.9	75.0/4.0
D-mark	18.0	39.0	34.7	49.0	28.5	43.1
	27.8/5.3	58.5/19.2	57.8/14.4	78.0/17.4	38.2/4.3	85.8/14.2
CRCE						
R.Rice	18.2	25.6	24.5	31.2	21.8	25.4
	37.5/0.0	64.8/0.0	66.1/0.0	87.2/0.0	57.9/0.0	72.7/0.0

experienced on a daily basis in the lower volume contracts.^{1/} For example, silver showed variation from 5.9% to 35.7%.

Broker traders account for a substantial portion of the trade and volume in the CBOT contracts. Over the entire period, broker traders executed about 25% to 60% of all trades and volume in most of the contracts. Average trade composition varied from a high of 62.9% in wheat to a low of 23.0% in the 30-day interest rate contract.

Average volume from broker traders varied from 61.0% in wheat to 24.6% in the 30-day interest rate contract. Silver again showed the greatest daily variation ranging from 4.3% to 74.0% in trades by broker traders and 5.2% to 31.3% in volume. These data indicate that broker traders are extremely important traders in the CBOT contracts.

As would be expected, volume exhibits the major role of broker traders when examined on the basis of CTI codes. Broker traders,

^{1/} Due to the use of percentages, wider swings are exhibited in the lower volume contracts with fewer traders. For example, a one trader change in a 10 trader pit makes for a substantial swing. The maximum number of broker traders and all traders in the five lowest volume contracts was, as follows:

<u>Contract</u>	<u>Maximum Number Broker Traders</u>	<u>Maximum Number All Traders</u>
Silver	5	19
30-day interest rate	4	55
Mace Wheat	3	35
D-mark	5	23
Rice	3	10

on average, provided 12% to 36% of the CTI1 volume in most contracts executed over the examined period. The average percentage ranged from a low of 5.0% in the MMI to a high of 36.6% in wheat. A range of 10% in daily values was common in the most active contracts. Silver and 30-day interest rate showed the greatest variation in CTI1 composition ranging from 0.8% to 70.6% and 0% to 80%, respectively. These CTI1 trades represent the speculative capital on the floor and are the cornerstone of the liquidity that futures markets provide. The market share of these trades held by broker traders is prima facie evidence of their integral role in the provision of futures market liquidity.

Broker traders dominate brokerage execution in these markets, on average accounting for in excess of 68% to 86% of the brokered trades in the largest markets. The broker trader share of brokerage executions (CTI2, CTI3 and CTI4) ranges from a low of 26.0% in the 30-day interest rate contract to a high of 86.3% in corn. Of the active contracts, broker traders' brokerage execution was lowest in the MMI at an average of 45.1%.

MACE. For the MACE T-Bond and wheat contracts broker traders represented about 8% of the traders executing trades during a trading session. The highest concentration of broker traders was found in the D-mark contract with an average of 18.0% of the traders being broker traders. On a daily basis, variation in the relative percentage of broker traders was highest in D-marks

ranging from 5.3% to 27.8%. The minimum daily volume for the percentage of broker traders was lowest in wheat at 3.3%.^{4/}

Despite constituting a small percentage of the trader population, the broker traders, on average, account for about one-third of the trades and volume in the MACE T-Bond and D-mark contracts. Broker traders' shares of trades and volume in the MACE wheat contract are 37.3% and 23.4%, respectively. Trade composition varied from a daily high of 58.5% in D-marks to a daily low of 6.4% in wheat. Volume composition varied from a daily high of 57.8% in D-marks to a daily low of 4.8% in wheat. The low number of traders and their substantial volume indicate that broker traders are some of the largest traders in the MACE contracts.

Volume composition, when examined on the basis of CTI, exhibits the role of broker traders. Broker traders provided an average of 11.6% and 28.5% of the CTI volume executed over the examined period in T-Bonds and D-marks, respectively. In wheat, broker traders provided 6.6% of the CTI volume. This percentage showed substantial variability ranging from a daily low of 0.9% to a daily high of 19.6% in wheat and from a daily low of 4.3% to a daily high of 38.2% in D-marks. Broker trader CTI volume exhibited its smallest variation in T-Bonds (7.4% to 22.0%).

^{4/} The difference between CBOT and MACE wheat has no ready explanation and needs further investigation.

Brokers traders dominate brokerage execution in these markets accounting for an average of almost 80% of the brokered trades in the largest market, T-Bonds and about 45% in wheat and D-marks. Again, the widest daily ranges were exhibited in the lower volume contracts -- wheat and D-marks.

CRCE. In the CRCE's Rough Rice contract broker traders represented about 18% of the traders executing trades over the period. There was large variation in broker trader concentration on individual days ranging from 0% to 37.5%.

These broker traders account for about one quarter of the trade and volume in the rice contract. Again daily variability was substantial from 0% to about 65%. These data indicate that broker traders are a major component of the rice market. Broker traders provided an average of 21.8% of the CT11 volume executed over the examined period; that is, one-fifth of the speculative capital on the floor. Broker traders market share of brokerage in the rice contract was comparable, accounting for about 25% of the brokered trades.

Contract Characteristics and Broker Traders

The relatively small sample size of examined contracts makes it difficult to readily discern relationships between contract characteristics, such as average volume and underlying commodity,

and broker traders' activity. These relationships require further study; however, preliminary observations are as follows:

CBOT. The highest volume CBOT contracts exhibited comparably high broker trader activity with the agricultural contracts exhibiting a slightly higher level than the interest rate contracts. Wheat had the highest level of broker trader activity. The one contract exhibiting high or moderate volume that stood out as exceptionally low in broker trader activity was the MMI contract. Our presumption is that lower activity in the MMI is reflective of equity-based futures market practices where, due to arbitrage activity, substantial volume is accounted for by traders that executed transactions exclusively for house accounts. In contrast, the agricultural contracts, where spread relationships are extremely important, have the highest level of broker trader activity.

As regards low volume contracts, silver and the 30-day interest rate contract provide an interesting contrast in the composition of broker trader activity. Silver, which is a sustained low-volume contract, exhibited considerable variation in broker trader activity. The variation of brokerage activity suggests that the broker traders are providing the capability for meeting increases in brokerage demand.

In contrast, the 30-day interest rate futures contract was introduced on October 3 and thus should be considered a new

contract. For a new contract, the data exhibit substantial variability; however, the proportion of broker trader activity seems to be generally consistent across total volume, CTI1 volume and brokerage.

MACE. No clear pattern was seen in the MACE contracts. The high volume contract, T-Bonds, and the low volume contract, D-marks, exhibited similar patterns of broker trader composition. Wheat, the moderate volume contract, stood out as an anomaly especially in light of the CBOT wheat contract. This deserves greater examination.

CRCE. The CRCE's rough rice is a low volume agricultural contract exhibiting a substantial market share by broker traders.

Summary

Expansion of our analysis of broker trading activity to cover more contracts over a longer time period adds support to the findings in the original report submitted by the Exchanges to the CFTC. While their activity varies across days, commodities and expirations, broker traders provide approximately one-fourth of the speculative capital present on the trading floor, and execute the majority of customer transactions.

The Exchanges are continuing their analysis of this complex issue.

TESTIMONY OF DR. SANFORD GROSSMAN
BEFORE THE HOUSE AGRICULTURE COMMITTEE

Sanford Grossman:

Thank you for inviting me. I am a professor of finance, I've been a professor at Princeton, University of Chicago, University of Pennsylvania and Stanford University. I've worked for the Board of Governors of the Federal Reserve.

The past 15 or so years has involved a study of futures and securities markets with special attention to the determinants of market liquidity and price discovery. My current research involves studying dual trading as well as the mathematics of transaction cost avoidance in securities and futures markets. I've worked for the New York Stock Exchange Kassenbach study of program trading and I've recently completed the theoretical part of my study of dual trading for the Chicago Board of Trade. I'd like to, if I could, summarize the result of that part of the study for you.

Some of this is going to sound, I'm afraid, overly academic, but that's where I come from. From my point of view, dual trading is said to occur when an entity sometimes trades as a broker for customers and at other times, trades for its own account. I find that dual trading is quite pervasive throughout the United States securities and futures markets as well as in financial and in commodities markets throughout the world.

The pervasiveness of dual trading is due to the fact that many of the skills and facilities required to be a good broker are also necessary to be a good trader. Dual trading increases the supply of both brokers and floor traders because a dual trader can earn income from two activities to cover his cost of training, his exchange seat and time spent on the floor. He has less idle time and facilities where he can switch from the activity on low demand to the activity on high demand.

I should just mention, as a professor, the notion that you can be spending your time on two different activities and be a dual trader is very common in my business as a professor of business, where we do both teaching and research and there is some overlap between the skills required to be a good teacher and the skills required to be a good researcher and when we don't spend our time teaching, we switch and do research, and sometimes when we do research for too long, you get a headache and you prefer to do some teaching. So, this notion that the skills and training that one has can be used for two activities, is something that every research professor is familiar with.

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Returning to dual trading, I find that dual trading has both a direct and indirect effect on the quality of customer services. The direct effect is an increase in quality and quantity of brokers. The fact that dual trading increases the supply of brokers means that the customer has more brokers to choose from and at a lower price. Furthermore, using a broker who is a good trader means higher quality execution for customers. The indirect benefit of dual trading derives from the increase in the liquidity of the market caused by the increase in the number of market makers. Parties who trade for their own accounts by buying at a low price and selling at a high price serve a market-making function. Thus, the ability for an entity to use its facilities for proprietary trading results in an increased presence of market-makers on the floor at times when their services are most needed. The more traders standing ready to trade make for a more liquid market with smoother price changes.

In order to aid in a comparative analysis on dual trading, I distinguished two types of dual trading. The first type, called simultaneous dual trading, occurs when a firm trades as a principal for its own account and an agent for its customer in the same transaction. This type of dual trading is prevalent in the securities market, currency and interest rate swap market and fixed-income market. As a matter of fact, most member firms of the NYSE call themselves broker-dealers. Thus, stock exchange firms sometimes act as brokers, trading for customers with brokers and at other times, trade both their house or proprietary account. Every major firm that you've heard of that trades stocks, trades for its house account and it also trades for customers. But it does something even more (these next words are unintelligible) _____ than that. Sometimes it does both at the same time by taking opposite positions of a customer transaction. Crossing a transaction, for example, on the floor of the NYSE, I've heard it said today that specialists are dual traders on the NYSE, but that's an understatement. Every major firm that's a member of the exchange both trades for its own accounts and for customers. Simultaneous dual trading does not take place in futures markets in the sense that firms don't simultaneously take the other side to their own customer trades.

The second type of dual trading, which is something that occurs in our futures markets, is what I call consecutive dual trading, and this occurs when a firm trades for its customers as an agent and at other times, trade for its own account as a principal. But the firm does not do both in the same transaction. Consecutive dual trading occurs in futures markets as well as in all of the markets in which there is simultaneous dual trading. Dual trading plays a particularly important role in futures markets as contrasted in securities markets. The fact that all trading of futures takes place on the exchange floor and that spread trading is an important part of hedging strategy, make the skills of a trader more necessary for a good futures broker.

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The immediacy required by the futures markets makes liquidity more important and therefore makes a larger supply of market makers more critical than it would be on a securities market.

There are three types of brokerage services that I have identified that the customer needs. The first service, called search, involves searching for the parties who are interested in being on the other side of the trade, that is the contra side, the contra party to the trade. The second service, called timing, involves obtaining and processing information to determine how long the wait for the arrival of the most advantageous contra party while being exposed to the risk of an adverse price movement. The third service, bargaining, involves actively bargaining among available contra parties to obtain the best price.

A securities broker can use his skills and sees first the prearranged sales upstairs. Upstairs search is often an effective substitute for the downstairs working of an order, where timing and bargaining are needed. A futures broker cannot prearrange trades upstairs. The brokerage firm cannot substitute search skills for trading skills. The order must be worked on the exchange floor. The floor broker must have the ability to trade in such a way on the floor on the exchange that he brings the other side to the floor at a good price for his customer. Therefore floor trading is relatively more important in the futures market than in the securities market.

Furthermore, much futures trading involves spreads where the customer wants to buy and sell two or more contracts simultaneously for a guaranteed net price. The customer's broker can execute the spread by trading with a local on the floor or the broker can execute the individual legs of the spread consecutively, the latter will be in the best interest of his customer if the broker is a skilled trader, since by trading each leg himself, the broker avoids paying the local a premium for the risk in trading the spread.

Such spread trading is inherently risky to a broker since after he executes one leg of the spread, his customer can hold him to a price for the other leg of the spread, which the broker might find impossible to achieve if the price moves after he does the first leg. This aspect of futures trades as well as the relatively high-underlined price volatility in many futures contracts increase the trading skills burden on a futures floor broker relatively to that of a securities floor broker.

Futures trading customers often have a high demand for immediacy because they are trading the hedge and underlying the spot market position. The fact that the immediacy of trade execution is extremely important to the futures customers, implies that they will have a greater demand for market makers than will be the case in markets where the cost of delayed executions is

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smaller. A commodity hedger bears great risk if he does not do his futures trade immediately. This risk may force him to trade using a market order, for example, to sell to the highest bidder currently available. If there are few market-makers, he will receive a relatively low price, that is his trade will have a high market impact. These futures markets have a great demand for traders who, in effect, serve in a market making function. The institution of dual trading permits this demand to be met at low costs.

(second tape begins here so first few words are cut off)

.....by increasing the broker population through allowing dual trading is something that will give the customer a tool in dealing with lazy brokers and help the customers get better fills. I guess the informal remarks that I have (these next words are unintelligible) _____.

Congressman Coleman:

Thank you very much Dr. Grossman, I appreciate it, I am not sure there's much the subcommittee can do about legislation on laziness. That's an area that we haven't had a great deal of success with in the past. Its been once or twice that I think Congress has attempted to legislate in that area and it hasn't worked out well at all.

I wanted to say, it's my understanding that you have been employed by the Chicago Board of Trade to carry out a comprehensive empirical study on dual trading, is that correct?

Sanford Grossman:

Yes.

Congressman Coleman:

Also, it is my understanding that you were employed by the Chicago Board of Trade earlier to carry out a study with regard to the proposed one-minute time bracketing regulations and you put out this booklet, is that correct?

Sanford Grossman:

That looks like a reprint of an article published in the Journal of Futures Markets, it's a reprint of a scholarly journal article.

Congressman Coleman:

You were also employed by the Chicago Board of Trade to carry out that study, is that correct?

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Sanford Grossman:

I think that the study that I did for the Chicago Board of Trade led to that paper. I am not sure that they (these next words are unintelligible) _____, but there definitely is a relationship.

Congressman Coleman:

So, you were employed to do that? I noticed in this article booklet that it states in there, and I quote, "the frequency is, itself, low" and at another point in there you state, I quote, "the frequency of dual trading is worth emphasizing, or the low frequencies of dual trading are worth emphasizing." Given that fact, how can dual trading be submitted as vital as it is since you stated back in 1986 it rarely occurs?

Sanford Grossman:

I think that, if I remember the context of that, that we, at the time, were concerned about front-running abuses and what we did is we studied a particular time bracket and in a particular bracket we did find very many instances where a dual trader had both traded for a customer and traded for his own account.

That doesn't mean that across other brackets that particular individuals didn't switch from becoming a broker to a trader who was a proprietary trader.

Congressman Coleman:

I guess the point that I'm making though, is that here on one hand you state back in '86 that this is something that is a low frequency situation, it's something that doesn't occur that often and if that's the case, I don't understand then, why it could be such a big deal this year. The other part of it is that from your testimony, you're talking about a theoretical overview. Does that mean that it has little fact and a lot of rhetoric when we talk about the question of dual trading?

Sanford Grossman:

Well, at the moment, I haven't yet done the empirical part of this study, I have finished outlining the work that needs to be done for the empirical part. I don't believe there is any rhetoric here. It is an outline, it is a theoretical framework we use to provide guidance as to what should be sought for in the data. Let me just emphasize again, with respect to your previous remark about the low frequency of dual trading; what we said is that dual trading has a low frequency in a particular bracket. But a given individual who trades only for himself, may, in another bracket, trade only for customers. The terms

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that we used in the paper that you were quoting, across two brackets, had engaged in a lot of dual trading in the sense that in bracket one he had traded only for himself and in bracket two he had traded only for customers. In each bracket alone, he had traded only for himself or only for his customer. So, on a bracket-for-bracket basis, there wasn't a great incidence of dual trading, but on across the whole day, there may well have been a large incidence of dual trading. It's the fact that there was not a whole lot of dual trading within a particular bracket that lessens the occasions where front-running abuses can occur.

Congressman Coleman:

You also stated in this pamphlet that a one-minute bracketing would constitute regulatory overkill.

Sanford Grossman:

Is that a quote?

Congressman Coleman:

No, its not a direct quote, but that's the (these next words are unintelligible)

Sanford Grossman:

I think what we had done at that time is look at the costs and benefits of the proposed regulation and we had used facts that measure the costs and facts on dual trading that estimated those benefits and at that time, we found that the facts were such that the cost seemed to be higher than the benefits.

Congressman Coleman:

And given the fact that, and certainly given your testimony given here today, before you've done the study, that you theoretically already support the concept of dual trading. You seem to have some very definite ideas before you've done the study with regard to that and also given the fact that you've been retained by the Chicago Board of Trade, who also supports dual trading, can you tell us that we are going to receive an objective study on this issue?

Sanford Grossman:

While you should understand that everybody agrees, I mean, correct me if I am wrong, that there are potential benefits to dual trading.

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Congressman Coleman:

That's not the question--so let me make a point, I don't want you taking off on another angle, because basically, what we're coming down to is that on one hand, you've testified that you are very strongly in support of dual trading and number two, you have been employed by a firm who strongly supports dual trading and number three, you are telling us that you are going to do a study. Now, it is hard for me to understand how you can have an objective study when you've already reached the conclusion. I don't understand, and I'm certainly not a Ph.D. and I don't go around doing studies, but it was always my understanding that when you go around conducting studies, that you were supposed to be somewhat objective and go in to try to learn an answer, not go in knowing the answer and trying to prove it's right.

Sanford Grossman:

Even though you are not a Ph.D., I should be articulate enough to be able to explain what I do and why I'm doing it and I hope you will allow me to do so.

This study and the outline I have given you discusses the benefits of dual trading--how you measure these benefits and where you should look for these benefits. There may well be costs for the dual trading and those costs have to do with the abuses that are associated with dual trading. What I think needs to be done to come to an appropriate economic cost-benefit analysis is to think where you would look for the benefits and measure the magnitude. What I have set out to you is where I would look for these benefits. Now the actual numerical magnitudes of these benefits are not something I am predisposed to, they may turn out to be economically negligible and if certain abuses arise that are not determined to be economically negligible in terms of their costs then, though I have illucidated where these benefits are, the fact that they are sufficiently small relative to the cost would mean that we should restrict dual trading. So, the mere fact that one has, from a theoretical point of view has said where the benefits would be sought after, doesn't mean that one is predisposed to the economic numerical magnitude of those benefits. I am certainly not so predisposed. I couldn't even, off the top of my head give you a ball park guess in dollars as to what the magnitude of these benefits are. I should mention to you that there are no studies of dual trading, there are no studies of the benefit of dual trading or the costs of dual trading. I think this is a completely new area and you know, I would urge you to allow studies to go further to measure the economic quantities that dollar values involve to get a notion of what the costs and benefits are over quantities being regulated.

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Congressman Coleman:

I'm not the one who is paying for it, you would have to talk to the folks who are paying for the study--the Chicago Board of Trade decided (these next words are unintelligible)

_____. Thank you very much Dr. Grossman, we appreciate your testimony.

APPENDIX 3

1988
DISCIPLINARY ACTION SUMMARY

DEPARTMENT	# OF CASES TP / TOTAL	# OF INDIVIDUALS/ FIRMS CITED TP / TOTAL	FINES / PENALTIES	
			TP	TOTAL
AUDITS	263 / 263	15 / 22	20,000 /	33,000
FINANCIAL SURVEILLANCE	0 / 139	0 / 20	0 /	50,000
INVESTIGATIONS	1,166 / 1,176	27 / 37	1,301,000 / 1,319,500	FINES 210 / 236 DAYS SUSP. 16 1/2 / 16 1/2 YEARS SUSP. 4 / 4 REPRIMANDS 2 / 2 PERMANENT BAR 2 / 2 C & D
MARKET SURVEILLANCE	7 / 27	7 / 10	146,000 /	209,500
R-R-R	28 / 28	19 / 19	13,750 /	13,750
TOTAL	1,464 / 1,633	68 / 116	1,480,750 /	1,633,750

TRADE PRACTICE VIOLATIONS

DEPARTMENT	INTERNAL/EXTERNAL/TOTAL	FINES - PENALTIES	
		INTERNAL/EXTERNAL/TOTAL	
AUDITS	16 / 0 / 16	20,000 / 0 /	20,000
FINANCIAL SURVEILLANCE	0 / 0 / 0	0 / 0 /	0
INVESTIGATIONS	16 / 11 / 27	1,241,500 / 59,500 / 1,301,000	FINES 174 / 36 / 210 DAYS SUSP. 16 1/2 / 0 / 16 1/2 YEARS SUSP. 4 / 0 / 4 REPRIMANDS 1 / 1 / 2 PERMANENT BAR 0 / 2 / 2 C & D
MARKET SURVEILLANCE	7 / 0 / 7	146,000 / 0 /	146,000
R-R-R	19 / 0 / 19	13,750 / 0 /	13,750
TOTAL	58 / 11 / 69	1,421,250 / 59,500 / 1,480,750	

10/10/89

1988
TOTAL CASES

<u>DEPARTMENT</u>	<u>INTERNAL</u>	<u>EXTERNAL</u>	<u># OF CASES</u>
AUDITS	263	0	263
FINANCIAL SURVEILLANCE	139	0	139
INVESTIGATIONS	949	227	1,176
MARKET SURVEILLANCE	27	0	27
R-R-R	<u>28</u>	<u>0</u>	<u>28</u>
TOTAL	1,406	227	1,633

TP CASES

<u>DEPARTMENT</u>	<u>INTERNAL</u>	<u>EXTERNAL</u>	<u>TOTAL</u>
AUDITS	263	0	263
FINANCIAL SURVEILLANCE	0	0	0
INVESTIGATIONS	949	217	1,166
MARKET SURVEILLANCE	7	0	7
R-R-R	<u>28</u>	<u>0</u>	<u>28</u>
TOTAL	1,247	217	1,464

DISCIPLINARY ACTION SUMMARY

DEPARTMENT	# OF CASES TP / TOTAL		# OF INDIVIDUALS/ FIRMS CITED TP / TOTAL		FINES / PENALTIES TP / TOTAL	
AUDITS	274	/ 274	7	/ 12	48,500	/ 62,500
FINANCIAL SURVEILLANCE	0	/ 196	0	/ 8	0	/ 23,500
INVESTIGATIONS	995	/ 1,002	27	/ 34	72,000	/ 77,550
					176	/ 219 DAYS SUSP.
					13	/ 13 REPRIMANDS
					1	/ 1 PERMANENT BAR
					1	/ 1 C & D
MARKET SURVEILLANCE	10	/ 53	10	/ 24	5,000	/ 54,000
	1,279	/ 1,525	44	/ 78	125,500	/ 217,550

TRADE PRACTICE VIOLATIONS

DEPARTMENT	INTERNAL/EXTERNAL/TOTAL		FINES - PENALTIES INTERNAL/EXTERNAL/TOTAL	
AUDITS	7	/ 0 / 7	48,500	/ 0 / 48,500
FINANCIAL SURVEILLANCE	0	/ 0 / 0	0	/ 0 / 0
INVESTIGATIONS	3	/ 24 / 27	47,000	/ 25,000 / 72,000 FINES
			166	/ 10 / 176 DAYS SUSP.
			13	/ 0 / 13 REPRIMANDS
			1	/ 0 / 1 PERMANENT BAR
			0	/ 1 / 1 C & D
MARKET SURVEILLANCE	10	/ 0 / 10	5,000	/ 0 / 5,000
TOTALS	20	/ 24 / 44	100,500	/ 25,000 / 125,500

1987
TOTAL CASES

<u>DEPARTMENT</u>	<u>INTERNAL</u>	<u>EXTERNAL</u>	<u># OF CASES</u>
AUDITS	274	0	274
FINANCIAL SURVEILLANCE	196	0	196
INVESTIGATIONS	814	188	1,002
MARKET SURVEILLANCE	<u>10</u>	<u>0</u>	<u>10</u>
TOTAL	1,294	188	1,482

TP CASES

<u>DEPARTMENT</u>	<u>INTERNAL</u>	<u>EXTERNAL</u>	<u>TOTAL</u>
AUDITS	274	0	274
FINANCIAL SURVEILLANCE	0	0	0
INVESTIGATIONS	814	181	995
MARKET SURVEILLANCE	<u>10</u>	<u>0</u>	<u>10</u>
TOTAL	1,098	181	1,279

101ST CONGRESS
1ST SESSION

S. _____

IN THE SENATE OF THE UNITED STATES

Mr. LEAHY introduced the following bill; which was read twice and referred to the Committee on _____

A BILL

To amend the Commodity Exchange Act to reauthorize such Act, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assem-*
3 *bled,*

4 SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

5 (a) SHORT TITLE.—This Act may be cited as the “Fu-
6 tures Trading Practices Act of 1989”.

7 (b) TABLE OF CONTENTS.—The table of contents is as
8 follows:

Sec. 1. Short title; table of contents.

Sec. 2. References to the Commodity Exchange Act.

TITLE I—AUTHORIZATION OF APPROPRIATIONS

Sec. 101. Authorization of appropriations.

TITLE II—FLOOR SURVEILLANCE AND DUAL TRADING

- Sec. 201. Duties of contract markets.
- Sec. 202. Commission oversight; deficiency orders.
- Sec. 203. Oral orders.

TITLE III—BROKER ASSOCIATIONS

- Sec. 301. Trading restrictions.
- Sec. 302. Disclosure.

TITLE IV—GOVERNING STRUCTURE

- Sec. 401. Governing structure.

TITLE V—FLOOR TRADER REGISTRATION

- Sec. 501. Definition of floor trader.
- Sec. 502. Unlawful to act as floor trader or broker without registration.
- Sec. 503. Registration of floor traders.

TITLE VI—PENALTIES

- Sec. 601. Fraudulent transactions.
- Sec. 602. Liability of futures commission merchants.
- Sec. 603. Civil damages.
- Sec. 604. Customer restitution.
- Sec. 605. Increased penalties.
- Sec. 606. Assessment of money penalties; collection of penalties.
- Sec. 607. False information to self-regulatory organizations.
- Sec. 608. Willful violations; false and misleading statements.
- Sec. 609. Complaints against registered persons; class action suits.
- Sec. 610. Penalties study and guidelines.

TITLE VII—ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

- Sec. 701. Definition of foreign futures authority.
- Sec. 702. Subpoena authority.
- Sec. 703. Disclosure by the Commission of information received from foreign futures authorities.
- Sec. 704. Disclosure by the Commission of information to foreign futures authorities.
- Sec. 705. Cooperation with foreign futures authorities.
- Sec. 706. Investigative assistance to foreign futures authorities.
- Sec. 707. Payments from foreign futures authorities.

TITLE VIII—GENERAL PROVISIONS

- Sec. 801. Ethics training for registrants.
- Sec. 802. Undercover operations and enforcement.
- Sec. 803. Access by GAO to information maintained by self-regulatory organizations.
- Sec. 804. Enhancement of registration requirements.
- Sec. 805. Hiring and compensation authority of Commission.
- Sec. 806. Service fees.
- Sec. 807. Appeals by registered futures associations.
- Sec. 808. Telemarketing fraud.
- Sec. 809. Venue; service of process.

Sec. 810. Study of delivery points for agricultural commodity contracts.

TITLE IX—EFFECTIVE DATE

Sec. 901. Effective date.

1 SEC. 2. REFERENCES TO THE COMMODITY EXCHANGE ACT.

2 Except as otherwise specifically provided, whenever
3 in this Act an amendment or repeal is expressed in terms
4 of an amendment to, or repeal of, a section or other provi-
5 sion, the reference shall be considered to be made to a
6 section or other provision of the Commodity Exchange Act
7 (7 U.S.C. 1 et seq.).

8 TITLE I—AUTHORIZATION OF 9 APPROPRIATIONS

10 SEC. 101. AUTHORIZATION OF APPROPRIATIONS.

11 Subsection (d) of section 12 (7 U.S.C. 16(d)) is
12 amended to read as follows:

13 “(d) There are authorized to be appropriated to carry
14 out this Act \$41,000,000 for fiscal year 1990, \$46,700,000
15 for fiscal year 1991, \$54,500,000 for fiscal year 1992,
16 \$63,300,000 for fiscal year 1993, and \$66,100,000 for
17 fiscal year 1994.”.

18 TITLE II—FLOOR SURVEILLANCE 19 AND DUAL TRADING

20 SEC. 201. DUTIES OF CONTRACT MARKETS.

21 Section 5a (7 U.S.C. 7a) is amended—

22 (1) by striking “and” at the end of paragraph
23 (11);

1 (2) by striking the period at the end of para-
2 graph (12) and inserting a semicolon; and

3 (3) by adding at the end the following new
4 paragraph:

5 "(13)(A) maintain and utilize a system to moni-
6 tor trading to detect and deter violations of this Act
7 related to the making of trades and the execution of
8 customer orders on the floor or subject to the rules
9 of such contract market. The system shall include—

10 "(i) physical observation of trading areas;

11 "(ii) audit trail and record keeping systems
12 able to capture essential data on the terms, par-
13 ticipants, and sequence of transactions (includ-
14 ing relevant data on unmatched trades and out-
15 trades);

16 "(iii) systems capable of reviewing such
17 data on trades effectively on a regular basis to
18 identify possible violations;

19 "(iv) resources to bring appropriate disci-
20 plinary actions; and

21 "(v) the assessment of meaningful penal-
22 ties against violators and the referral of appro-
23 priate cases to the Commission.

24 "(B) The audit trail system of the contract
25 market shall accurately record—

1 “(i) the times of trades in increments of no
2 more than 1 minute in length; and

3 “(ii) the sequence of trades for each floor
4 trader and broker.

5 “(C) Beginning 3 years after the date of enact-
6 ment of this paragraph, the audit trail system of the
7 contract market shall—

8 “(i) record all trades accurately and
9 promptly—

10 “(I) by a source independent of the
11 person making the trade and continually re-
12 corded in the record of the contract market
13 (including through a mechanism that
14 records the time of execution of each trade
15 automatically when entered by such person
16 and records essential data in a form that
17 cannot be altered except in a manner that
18 will leave a complete and independent
19 record of any such alteration); and

20 “(II) with precision adequate to deter-
21 mine the sequence of all trades by each
22 floor trader and floor broker and, to the
23 fullest extent feasible as determined by the
24 Commission by rule, the sequence of all

1 trades made by all floor traders and floor
2 brokers; and

3 "(ii) for customer orders, to the extent fea-
4 sible as determined by the Commission, include
5 a record by a source independent of persons
6 processing or executing such order (including
7 by a mechanism that records such data auto-
8 matically when entered by such persons in a
9 form that cannot be altered except in a manner
10 that will leave a complete and independent
11 record of any such alteration) of—

12 "(I) the time each such order is re-
13 ceived on the floor of the board of trade
14 and is reported from the floor of the board
15 of trade as executed with precision ade-
16 quate to determine, for each futures com-
17 mission merchant or floor broker, the se-
18 quence in which all such orders are re-
19 ceived on and reported from such floor;
20 and

21 "(II) the time each such order is re-
22 ceived by the floor broker for execution
23 with precision adequate to determine the
24 sequence in which such orders are received
25 by each floor broker and, to the fullest

1 extent feasible as determined by the Com-
2 mission by rule, the interval between the
3 times of receipt and execution of each such
4 order by the floor broker."

5 SEC. 202. COMMISSION OVERSIGHT; DEFICIENCY ORDERS.

6 (a) IN GENERAL.—The Act is amended by inserting
7 after section 8d (7 U.S.C. 12d) the following new section:

8 "SEC. 2a. COMMISSION OVERSIGHT; DEFICIENCY ORDERS.

9 "(a) ASSESSMENTS.—Not later than 1 year after the
10 date of enactment of this section, and at least once every 2
11 years thereafter, the Commission shall assess the trade
12 monitoring system of each contract market implemented
13 pursuant to section 5a(13) to determine its capacity and
14 effectiveness in detecting and deterring violations of this
15 Act.

16 "(b) ORDERS.—

17 "(1) CAUSES.—The Commission shall issue an
18 interim order in accordance with paragraph (2) if the
19 Commission finds at any time that a contract market
20 has failed to demonstrate that—

21 "(A) the trade monitoring system imple-
22 mented pursuant to section 5a(13) complies
23 with the audit trail standards of such section;

24 "(B) such system is capable of and is
25 being used to review data on transactions on a

1 regular basis to detect violations related to
2 making trades and executing customer orders on
3 the floor or subject to the rules of such contract
4 market, including—

5 “(i) all types of violations attributable
6 to dual trading; and

7 “(ii) to the full extent feasible as de-
8 termined by the Commission, all other
9 types of violations involving the making of
10 trades and the execution of customer
11 orders;

12 “(C) the contract market is utilizing infor-
13 mation gathered through such system on a con-
14 sistent basis to bring appropriate disciplinary ac-
15 tions against violators;

16 “(D) the contract market is committing re-
17 sources to such system necessary for such
18 system to be effective in detecting and deterring
19 such violations, including adequate staff to de-
20 velop and prosecute disciplinary actions;

21 “(E) the contract market is assessing
22 meaningful penalties for proven violations; or

23 “(F) the contract market is otherwise satis-
24 fying the duties of the contract market under
25 section 5a(13).

1 “(2) CONTENTS.—An order issued under this
2 subsection shall specify—

3 “(A) the deficiencies the Commission has
4 found in the trade monitoring system of the
5 contract market;

6 “(B) corrective action that the contract
7 market must take and an acceptable timetable
8 for such corrective action; and

9 “(C) a date, not less than 20 days from the
10 date of issuance of the interim order, when such
11 order will become final, subject to subsection
12 (d).

13 “(3) REMEDIES.—Such order may require the
14 contract market to—

15 “(A) institute appropriate improvements in
16 its trade monitoring, compliance, or disciplinary
17 systems necessary to bring such systems into
18 compliance with the standards of section 5a(13)
19 and this section;

20 “(B) satisfy stated objective performance
21 criteria for compliance with such standards;

22 “(C) employ additional staff, upgrade or
23 reconfigure existing systems for collecting or
24 processing relevant data on trading and trader or
25 broker activity, or deploy new such systems;

1 “(D) suspend the privilege of dual trading
2 in such contract market, subject to the stand-
3 ards, exceptions, and duration provisions of sub-
4 section (c); or

5 “(E) take any combination of the actions
6 described in subparagraphs (A) through (D).

7 “(4) REMOVAL.—If the Commission finds, after
8 notice and opportunity for a hearing on the record
9 prior to such order becoming final, that a named of-
10 ficer, director, committee member, or employee of
11 such contract market has willfully—

12 “(A) failed to fulfill the official responsi-
13 bilities of such person with respect to such
14 office;

15 “(B) abused the authority of such person;
16 or

17 “(C) otherwise acted in a manner render-
18 ing such person unfit for service in the official
19 position of such person.

20 the Commission may issue an order under this sec-
21 tion to remove such officer, director, committee
22 member, or employee.

23 “(5) DESIGNATION AS CONTRACT MARKET.—Not-
24 withstanding section 6, during the period that an in-
25 terim or final order under this section is in effect, the

1 Commission may refrain from approving any appli-
2 cation for designation as a contract market made by
3 the exchange whose contract market is the subject of
4 such order.

5 "(c) DUAL TRADING.—

6 "(1) IN GENERAL.—Within 1 year after the date
7 of enactment of this section, the Commission shall
8 suspend the privilege of dual trading on each con-
9 tract market, pursuant to an order issued under sub-
10 section (b), unless the Commission finds, as part of
11 the first assessment made of such contract market
12 under subsection (a) that the contract market has
13 failed to demonstrate that—

14 "(A) the trade monitoring system in place
15 at the contract market fully satisfies the audit
16 trail standards under subsection (b)(1)(A), and
17 otherwise satisfies the standards of subsection
18 (b)(1), such that such system is capable of and
19 is being used to detect and bring appropriate
20 disciplinary actions with regard to violations at-
21 tributable to dual trading at such contract
22 market; or

23 "(B)(i) there is a substantial likelihood that
24 a dual trading suspension would harm the

1 public interest in hedging and price basing at
2 such contract market; and

3 "(ii) other remedies under subsection (b)
4 are more appropriate.

5 "(2) EXCEPTIONS.—A Commission order sus-
6 pending dual trading may provide for exceptions to
7 ensure fairness and orderly trading in such contract
8 market (including, where appropriate, a reasonable
9 phase-in period, a limitation of the suspension to
10 specified contracts, exceptions for certain spread
11 transactions, corrections of trading errors, or allow-
12 ing a customer to designate in writing not less than
13 once annually a named floor broker to execute
14 orders for such customer).

15 "(3) DURATION.—Such suspension shall remain
16 in effect until the Commission makes the finding re-
17 quired under paragraph (1).

18 "(d) RECISSION, MODIFICATION, OR DELAY OF
19 ORDERS.—Before any interim order issued by the Commis-
20 sion under subsection (b) may become final, the Commis-
21 sion shall—

22 "(1) provide the affected contract market with a
23 reasonable opportunity for a hearing in order to peti-
24 tion the Commission to rescind, modify, or delay
25 such order on the ground that—

1 “(A) the deficiencies cited by the Commis-
2 sion have been corrected or are being corrected
3 under an expeditious timetable acceptable to the
4 Commission;

5 “(B) the finding of the Commission that
6 the trade monitoring system of the contract
7 market is deficient is not based on substantial
8 evidence;

9 “(C) the method used by the Commission
10 for assessing the effectiveness or accuracy of
11 the audit trail system of the contract market for
12 purposes of paragraphs (1) and (2) of subsection
13 (b) was arbitrary and capricious; or

14 “(D) the timetable proposed by the Com-
15 mission in its interim order for corrective action
16 by the contract market or the particular correc-
17 tive action proposed is arbitrary, capricious, or
18 an abuse of discretion; and

19 “(2) rule on such petition.

20 “(e) PENALTIES.—Violation of an order issued under
21 subsection (b) shall be considered a violation of an order
22 of the Commission for purposes of—

23 “(1) establishing liability and assessing penal-
24 ties against a contract market or any director, officer,
25 agent, or employee thereof under section 6b; or

1 “(2) initiating proceedings under section 5b or
2 6(a).

3 “(f) JUDICIAL REVIEW.—A person aggrieved by an
4 order issued under subsection (b) that has become final
5 may obtain judicial review of the order in the same manner
6 and under the same terms and conditions as are provided
7 in section 8a(9).

8 “(g) REPORTS.—

9 “(1) REPORTS ON ORDERS.—Within 3 days of
10 the issuance of any interim or final order under this
11 section or a finding under subsection (c)(1) with re-
12 spect to dual trading, the Commission shall report to
13 the Committee on Agriculture of the House of Rep-
14 resentatives and the Committee on Agriculture, Nu-
15 trition, and Forestry of the Senate on such order or
16 finding, including a description of—

17 “(A) the contract market involved;

18 “(B) the deficiencies alleged in the trade
19 monitoring system at such contract market; and

20 “(C) the remedies sought by such order.

21 “(2) ANNUAL REPORTS.—The Commission shall
22 report annually to the Committee on Agriculture of
23 the House of Representatives and the Committee on
24 Agriculture, Nutrition, and Forestry of the Senate on

1 actions taken to carry out this section, including a
2 description of—

3 “(A) the findings of the Commission with
4 respect to each trade monitoring system at a
5 contract market examined by the Commission
6 during such period; and

7 “(B) any interim or final order issued by
8 the Commission under this section based on de-
9 ficiencies the Commission has uncovered in
10 such systems, including an analysis of the reme-
11 dies imposed against, and the corrective action
12 taken by, the contract market pursuant to such
13 order,

14 “(h) DEFINITION OF DUAL TRADING.—As used in this
15 section, the term ‘dual trading’ means the execution of
16 customer orders by a floor broker on any trading day
17 during which the floor broker has executed any trade in the
18 same contract market for—

19 “(1) the account of the floor broker;

20 “(2) an account for which the broker has trad-
21 ing discretion; or

22 “(3) an account controlled by a person with
23 whom such broker is subject to trading restrictions
24 under section 4j(3).”.

25 (b) STUDY.—

1 (1) IN GENERAL.—Not later than 2 years after
2 the date of enactment of this section, the Commodity
3 Futures Trading Commission shall submit to the
4 Committee on Agriculture of the House of Repre-
5 sentatives and the Committee on Agriculture, Nutri-
6 tion, and Forestry of the Senate a report that con-
7 tains—

8 (A) an assessment of the progress of each
9 contract market in developing and implementing
10 systems to record the times of transactions inde-
11 pendently, precisely, and completely as required
12 under section 5a(13) of the Commodity Ex-
13 change Act (as added by section 201 of this
14 Act); and

15 (B) recommendations as to whether any
16 extension of time for the completion of such
17 systems or any modification of the standards
18 contained in such section is appropriate.

19 (2) GAO VIEWS.—The Comptroller General of
20 the United States shall state to Congress the views of
21 the Comptroller General with regard to such report.

22 SEC. 203. ORAL ORDERS.

23 (a) IN GENERAL.—Section 4c (7 U.S.C. 6c) is amend-
24 ed by adding at the end the following new subsection:

1 “(g) The placing of oral orders on contract market
2 floors for member-for-member trades shall be barred
3 unless such orders are made pursuant to rules that the
4 Commission adopts and certifies to Congress will require
5 standards and procedures designed to ensure that such
6 orders are not used to facilitate violations of this Act.”.

7 (b) EFFECTIVE DATE.—The amendment made by sub-
8 section (a) shall become effective 270 days after the date
9 of enactment of this Act.

10 **TITLE III—BROKER ASSOCIATIONS**

11 **SEC. 301. TRADING RESTRICTIONS.**

12 (a) IN GENERAL.—Section 4j (7 U.S.C. 6j) is amended
13 by adding at the end the following new paragraph:

14 “(3)(A) Except as provided in subparagraph (B), a
15 floor trader or floor broker may not make a trade or exe-
16 cute an order of a customer if such trader or broker knows
17 the opposite party to the transaction to be a floor broker or
18 floor trader with whom such trader or broker has a rela-
19 tionship as—

20 “(i) a partner in a partnership;

21 “(ii) an employer or employee;

22 “(iii) employees of the same employer; or

23 “(iv) such other affiliation as the Commission
24 may specify by rule.

1 “(B) Subparagraph (A) shall not apply if the Com-
2 mission has adopted rules that the Commission certifies to
3 Congress require procedures and standards designed to
4 prevent violations of this Act attributable to the trading
5 described in subparagraph (A).”.

6 (b) EFFECTIVE DATE.—The amendment made by sub-
7 section (a) shall become effective 270 days after the date
8 of enactment of this Act.

9 SEC. 302. DISCLOSURE.

10 Section 5a (7 U.S.C. 7a) (as amended by section 201
11 of this Act) is further amended by adding at the end the
12 following new paragraph:

13 “(14) provide for disclosure to the exchange
14 and the Commission of any trade, business, or finan-
15 cial association, affiliation, partnership, cost-, profit-,
16 or capital-sharing agreement, or other formal or in-
17 formal such arrangement among or between floor
18 brokers and traders on such contract market;”.

19 **TITLE IV—GOVERNING STRUCTURE**

20 SEC. 401. GOVERNING STRUCTURE.

21 (a) CONTRACT MARKETS.—Section 5a (7 U.S.C. 7a)
22 (as amended by sections 201 and 302 of this Act) is further
23 amended by adding at the end the following new para-
24 graphs:

1 “(15) provide for meaningful representation on
2 the governing board of the contract market’s board
3 of trade of a diversity of interests, including—

4 “(A) futures commission merchants;

5 “(B) producers of, and consumers, proces-
6 sors, distributors, or merchandisers of, principal
7 commodities traded on the exchange;

8 “(C) floor brokers and traders;

9 “(D) participants in a variety of pits or
10 principal groups of commodities traded on the
11 exchange;

12 “(E) no less than 20 percent of the mem-
13 bers of such board, comprised of nonmembers
14 of such contract market’s board of trade with—

15 “(i) expertise in futures trading, or the
16 regulation thereof, in commodities traded
17 through contracts on the exchange; or

18 “(ii) other eminent qualifications
19 making such person capable of participat-
20 ing in and contributing to board delibera-
21 tions;

22 “(16)(A) provide on all major disciplinary com-
23 mittees for a diversity of membership sufficient to
24 ensure fairness and to prevent special treatment or

1 preference for any person in the conduct of discipli-
2 nary proceedings and the assessment of penalties.

3 "(B) A major disciplinary committee hearing a
4 disciplinary matter shall include—

5 "(i) qualified persons representing seg-
6 ments of the exchange membership other than
7 that of the subject of the proceeding; and

8 "(ii) where appropriate to carry out the
9 purposes of this paragraph, qualified persons
10 who are not members of the exchange.

11 "(C) If a contract market takes final discipli-
12 nary action against a member for a violation that in-
13 volves the execution of a customer order and results
14 in financial harm to such customer, the contract
15 market shall promptly inform the ultimate customer
16 of the disciplinary action and the principal facts
17 thereof. The Commission and futures commission
18 merchant carrying the account for such customer
19 shall cooperate with the contract market in carrying
20 out its duties under this paragraph.

21 "(17)(A) provide for the avoidance of conflict
22 of interest in all deliberations by the governing board
23 and any disciplinary and oversight committees.

24 "(B) The contract market shall adopt rules that
25 require that a board or committee member abstain

1 from participation in voting and confidential delib-
2 erations on an issue if the member, an affiliated firm
3 or business, a family member, or any other individ-
4 ual with whom the member has a business or em-
5 ployment relationship is, to the knowledge of such
6 member, a specific and actual party in interest to the
7 issue before the board.

8 "(C) Notwithstanding any other provision of
9 this paragraph, in adopting any contract market rule
10 or order that is likely to affect prices in any actively
11 trading contract market (including any motion to
12 adopt an emergency measure for a nonphysical
13 emergency), the contract market shall ensure that—

14 "(i) any party with access to material, non-
15 public information about such deliberations
16 gained through the position of the party as an
17 exchange employee or official shall be prevent-
18 ed from—

19 "(I) trading, directly or indirectly, in a
20 manner to take improper advantage of such
21 information; or

22 "(II) transmitting such information to
23 any other party, except as necessary for the
24 performance of official duties; and

1 “(ii) prior to such deliberations, each par-
2 ticipant shall disclose to the board or committee
3 the position of the participant in the contract
4 market under discussion, along with all posi-
5 tions held in accounts at the affiliated firm of
6 the participant of which the participant is aware,
7 in such form as will provide effective informa-
8 tion to the board while maintaining appropriate
9 confidentiality of trading information.

10 “(D) If any board or committee member dis-
11 closing such positions under subparagraph (C)(ii)
12 participates in such deliberations, the minutes of
13 such deliberations shall clearly reflect this fact; and

14 “(18) provide that no member found by the
15 Commission, a contract market, a registered futures
16 association, or a court of competent jurisdiction to
17 have violated this Act or any other provision of law
18 that would reflect on the fitness of the member to
19 serve in a fiduciary position, may serve on any con-
20 tract market oversight or disciplinary panel for an
21 appropriate period (as defined by Commission
22 rule).”.

23 (b) REGISTERED FUTURES ASSOCIATIONS.—Section
24 17(b) (7 U.S.C. 21(b)) is amended by adding at the end the
25 following new paragraphs:

1 “(11) such association provides for meaningful
2 representation on the governing board of such asso-
3 ciation of a diversity of membership interests and
4 provides that no less than 20 percent of the members
5 of such board be comprised of qualified nonmembers
6 of such association.

7 “(12)(A) such association provides on all major
8 disciplinary committees for a diversity of member-
9 ship sufficient to ensure fairness and to prevent spe-
10 cial treatment or preference for any person in the
11 conduct of disciplinary proceedings and the assess-
12 ment of penalties.

13 “(B) A major disciplinary committee hearing a
14 disciplinary matter shall include—

15 “(i) qualified persons representing seg-
16 ments of the association membership other than
17 that of the subject of the proceeding; and

18 “(ii) where appropriate to carry out the
19 purposes of this paragraph, qualified persons
20 who are not members of the association.”.

21 (c) IMPLEMENTATION.—Not later than 270 days after
22 the date of enactment of this Act, the Commodity Futures
23 Trading Commission shall adopt such rules as are neces-
24 sary to carry out the amendments made by subsections (a)
25 and (b), including rules that—

1 (1) specify membership categories that shall be
2 represented on disciplinary panels;

3 (2) define "major disciplinary committee" for
4 purposes of sections 5a(16) and 17(b)(12) of the
5 Commodity Exchange Act (as added by subsections
6 (a) and (b), respectively);

7 (3) specify the conditions under which such
8 panels shall include qualified persons who are not
9 members of the exchange or association, which shall
10 include at a minimum—

11 (A) any disciplinary action where the sub-
12 ject of such action is a member of the contract
13 market or association governing board or of any
14 major disciplinary committee of such contract
15 market or association; and

16 (B) any disciplinary action involving a
17 claim that the subject of such action manipulat-
18 ed or attempted to manipulate the price of a
19 commodity or future or option;

20 (4) establish procedures for informing customers
21 of disciplinary actions in accordance with section
22 5a(16)(C) of such Act;

23 (5) provide guidance in determining what are
24 acceptable forms of and procedures for the disclo-

1 sure by members of contract market boards or com-
2 mittees under section 5a(17)(C) of such Act; and

3 (6) define the appropriate periods during which
4 members found to have violated relevant laws may
5 not serve on exchange oversight or disciplinary
6 panels under section 5a(18) of such Act.

7 **TITLE V—FLOOR TRADER**
8 **REGISTRATION**

9 **SEC. 501. DEFINITION OF FLOOR TRADER.**

10 Section 2(a)(1)(A) (7 U.S.C. 2, 4) is amended by
11 adding at the end the following new sentence: "The term
12 'floor trader' shall mean any person who, in or surround-
13 ing any 'pit', 'ring', 'post', or other place provided by a
14 contract market for the meeting of persons similarly en-
15 gaged, purchases or sells solely for such person's own ac-
16 count any commodity for future delivery on or subject to
17 the rules of any contract market."

18 **SEC. 502. UNLAWFUL TO ACT AS FLOOR TRADER OR BROKER**
19 **WITHOUT REGISTRATION.**

20 (a) **IN GENERAL.**—Section 4e (7 U.S.C. 6e) is amend-
21 ed to read as follows:

22 **"SEC. 4e. UNLAWFUL TO ACT AS FLOOR TRADER OR BROKER**
23 **WITHOUT REGISTRATION.**

24 "It shall be unlawful for any person to act as—

1 “(1) a floor trader in executing purchases and
2 sales; or

3 “(2) a floor broker in executing an order for the
4 purchase or sale of any commodity for future deliv-
5 ery, or involving any contract of sale of any com-
6 modity for future delivery, on or subject to the rules
7 of any contract market,
8 unless such person shall have registered, under this Act,
9 with the Commission as such floor trader or floor broker
10 and such registration shall not have expired nor been sus-
11 pended nor revoked.”.

12 (b) EFFECTIVE DATE.—The amendment made by sub-
13 section (a) shall become effective 180 days after the date
14 of enactment of this Act.

15 SEC. 503. REGISTRATION OF FLOOR TRADERS.

16 The Act is amended—

17 (1) in sections 4f(1), 4g(1), and 6d(1) (7 U.S.C.
18 6f(1), 6g(1), 13a-2(1)), by striking “or floor broker”
19 and inserting “floor broker, or floor trader”;

20 (2) in section 6d(8)(A) (7 U.S.C. 13a-2(8)(A)),
21 by inserting “, floor trader,” after “floor broker”;

22 (3) in section 8a(1), (7 U.S.C. 12a(1)), by strik-
23 ing “and floor brokers” and inserting “floor bro-
24 kers, and floor traders”; and

1 (4) in sections 8a(2)(C)(i), 8a(2)(D)(ii), and
2 8a(3)(E)(ii) (7 U.S.C. 12a(2)(C)(i), 12a(2)(D)(ii), and
3 12a(3)(E)(ii)), by inserting "floor trader," after
4 "floor broker,".

5 TITLE VI—PENALTIES

6 SEC. 601. FRAUDULENT TRANSACTIONS.

7 The first paragraph of section 4b (7 U.S.C. 6b) is
8 amended—

9 (1) by striking "or" at the end of subparagraph
10 (C);

11 (2) by striking the period at the end of subpara-
12 graph (D) and inserting "; or"; and

13 (3) by adding at the end the following new sub-
14 paragraph:

15 "(E) to engage in any transaction, practice, or
16 course of business that operates as a fraud or deceit
17 on any person, or to employ any device, scheme, or
18 artifice to defraud any person."

19 SEC. 602. LIABILITY OF FUTURES COMMISSION MERCHANTS.

20 Section 4d (7 U.S.C. 6d) is amended—

21 (1) by inserting "(a)" after the section designa-
22 tion; and

23 (2) by adding at the end the following new sub-
24 section:

1 “(b)(1) In any action brought under section 14(a) or
2 22(a), or under procedures provided by a contract market
3 or a registered futures association under section 5a(11) or
4 17(b)(11), if such action arises from a violation in the
5 making of a trade or execution of an order on the floor or
6 subject to the rules of a contract market, a futures commis-
7 sion merchant that selected or contracted with a floor
8 broker (who is not an employee of such futures commis-
9 sion merchant) to conduct the trade or execute the order
10 from which such claim arose shall be considered the prin-
11 cipal of such floor broker, and the floor broker shall be
12 considered the agent of such futures commission merchant,
13 if both the floor broker and the futures commission mer-
14 chants are named as defendants in such action, for pur-
15 poses of assessing—

16 “(A) any award of damages proximately caused
17 by such violation; and

18 “(B) if such futures commission merchant will-
19 fully and intentionally failed to exercise due dili-
20 gence in selecting the floor broker or monitoring the
21 execution of the customer order at issue in such
22 action, any award of punitive or exemplary damages
23 based on such claim.

24 “(2) Nothing in this subsection shall affect or limit
25 the liability of a futures commission merchant for the act,

1 omission, or failure of an employee acting for such futures
2 commission merchant pursuant to section 2(a)(1)(A).''.

3 SEC. 603. CIVIL DAMAGES.

4 (a) DUTIES OF CONTRACT MARKETS.—Section 5a(11)
5 (7 U.S.C. 7a(11)) is amended—

6 (1) by striking ''(i)'' and inserting ''(A)'';

7 (2) by striking ''voluntary and (ii)'' and insert-
8 ing ''voluntary, (B)''; and

9 (3) by inserting after ''market'' the following:
10 '' , and (C) in the case of a claim arising from a vio-
11 lation in the making of a trade or the execution of an
12 order on the floor or subject to the rules of a con-
13 tract market, such procedure shall provide, to the
14 extent appropriate, for payment to a customer of pu-
15 nitive or exemplary damages in addition to losses
16 proximately caused by the violation''.

17 (b) COMPLAINTS AGAINST REGISTERED PERSONS.—Sec-
18 tion 14(a) (7 U.S.C. 18(a)) is amended by striking ''award-
19 ing actual damages proximately caused by such violation''
20 and inserting ''awarding—

21 ''(1) actual damages proximately caused by
22 such violation; and

23 ''(2) in the case of any action arising from a
24 willful and intentional violation involving the
25 making of a trade or execution of an order on the

1 floor or subject to the rules of a contract market, pu-
2 nitive or exemplary damages equal to no more than
3 two times the amount of such actual damages”.

4 (c) REGISTERED FUTURES ASSOCIATIONS.—Section
5 17(b)(10) is amended—

6 (1) by striking “(i)” and inserting “(A)”;

7 (2) by striking “voluntary and (ii)” and insert-
8 ing “voluntary, (B)”;

9 (3) by inserting after “market” the following:
10 “, and (C) in the case of a claim arising from a vio-
11 lation in the making of a trade or the execution of an
12 order on the floor or subject to the rules of a con-
13 tract market, such procedure shall provide, to the
14 extent appropriate, for payment to a customer of pu-
15 nitive or exemplary damages in addition to losses
16 proximately caused by the violation”.

17 (d) PRIVATE RIGHTS OF ACTION.—Section 22(a) (7
18 U.S.C. 25(a)) is amended by adding at the end the follow-
19 ing new paragraph:

20 “(3) In any action arising from a willful and inten-
21 tional violation in the making of a trade or execution of an
22 order on the floor or subject to the rules of a contract
23 market, the person referred to in paragraph (1) shall be
24 liable for—

1 “(A) actual damages proximately caused by
2 such violation; and

3 “(B) punitive or exemplary damages equal to
4 no more than two times the amount of such actual
5 damages.”.

6 SEC. 604. CUSTOMER RESTITUTION.

7 The tenth sentence of section 6(b) (7 U.S.C. 9) is
8 amended—

9 (1) by inserting “(1)” after “may” the first
10 place it appears;

11 (2) by striking “and, if” and inserting “(2) if”;

12 (3) by striking “may suspend” and inserting
13 “suspend”;

14 (4) by striking “and may” and inserting “(3)”;
15 and

16 (5) by inserting before the period the following:
17 “and (4) require restitution to customers of damages
18 proximately caused by such violation”.

19 SEC. 605. INCREASED PENALTIES.

20 (a) IN GENERAL.—Sections 6(b), 6(c), and 9 (7 U.S.C.
21 9, 13b, and 13) are each amended by striking “\$100,000”
22 each place it appears and inserting “the higher of
23 \$100,000 or triple the monetary gain to such person”.

1 (b) NONENFORCEMENT OF RULES OF GOVERNMENT OR
2 OTHER VIOLATIONS.—Section 6b (7 U.S.C. 13a) is amend-
3 ed—

4 (1) by striking “\$100,000” each place it ap-
5 pears and inserting “\$500,000”; and

6 (2) in the last sentence, by striking “the appro-
7 priateness of such penalty to the net worth of the of-
8 fending person and”.

9 SEC. 606. ASSESSMENT OF MONEY PENALTIES; COLLECTION OF
10 PENALTIES.

11 Subsection (d) of section 6 (7 U.S.C. 9a) is amended
12 to read as follows:

13 “(d)(1) In determining the amount of the money pen-
14 alty assessed under subsection (b), the Commission shall
15 consider the appropriateness of such penalty to the gravity
16 of the violation.

17 “(2)(A) Except as provided in subparagraphs (B) and
18 (C), if a money penalty is assessed against a person under
19 subsection (b), such person shall beginning 15 days after
20 such assessment—

21 “(i) be prohibited automatically from trading on
22 all contract markets; and

23 “(ii) if the person is registered with the Com-
24 mission, be suspended automatically,

1 until such person shows to the satisfaction of the Commis-
2 sion that payment of such amount, with interest on such
3 payment to the date of payment, has been made.

4 “(B) Subparagraph (A) shall not apply if the person
5 on whom the penalty is assessed shows to the satisfaction
6 of the Commission, within 15 days from the expiration of
7 the period allowed for payment of such penalty, that—

8 “(i) an appeal as authorized by subsection (b)
9 has been taken; or

10 “(ii) payment of the full amount of the penalty
11 has been made.

12 “(C) If on appeal the Commission prevails or if the
13 appeal is dismissed, the automatic prohibition against trad-
14 ing and suspension of registration imposed under subpara-
15 graph (A) shall become effective on the expiration of 30
16 days from the date of judgment on the appeal.

17 “(3) If the person on whom a money penalty is im-
18 posed under subsection (b) fails to pay such penalty after
19 the lapse of the period allowed for appeal or after the af-
20 firmance of such penalty, the Commission shall refer the
21 matter to the Attorney General who shall recover such
22 penalty by action in the appropriate United States district
23 court.”.

1 SEC. 607. FALSE INFORMATION TO SELF-REGULATORY ORGANI-
2 ZATIONS.

3 Section 9 (7 U.S.C. 13) is amended by adding at the
4 end the following new subsection:

5 “(g) It shall be a felony punishable by a fine of not
6 more than \$100,000 or imprisonment for not more than 5
7 years, or both, together with the costs of prosecution, for
8 any person knowingly and willfully to falsify, conceal, or
9 cover up by any trick, scheme, or artifice a material fact,
10 make any false, fictitious, or fraudulent statements or rep-
11 resentations, or make or use any false writing or document
12 knowing the same to contain any false, fictitious, or fraud-
13 ulent statement or entry to a contract market, board of
14 trade, or futures association designated or registered under
15 this Act acting in furtherance of its official duties under
16 this Act.”.

17 SEC. 608. WILLFUL VIOLATIONS; FALSE AND MISLEADING STATE-
18 MENTS.

19 Section 9 (7 U.S.C. 13) (as amended by section 607
20 of this Act) is further amended by adding at the end the
21 following new subsection:

22 “(h) Any person who willfully violates and provision
23 of this Act, or any rule or regulation thereunder the viola-
24 tion of which is made unlawful or the observance of which
25 is required under the terms of this Act, or any person who
26 willfully and knowingly makes, or causes to be made, any

1 statement in any application, report, or document required
2 to be filed under this Act or any rule or regulation thereun-
3 der or any undertaking contained in a registration state-
4 ment required under this Act, or by any contract market or
5 registered futures association in connection with an appli-
6 cation for membership or participation therein or to
7 become associated with a member thereof, which state-
8 ment was false or misleading with respect to any material
9 fact, shall on conviction be fined not more than \$500,000,
10 or imprisoned not more than 5 years, or both, except that
11 no person shall be subject to imprisonment under this sub-
12 section for the violation of any rule or regulation if the
13 person proves that the person had no knowledge of such
14 rule or regulation.”.

15 SEC. 609. COMPLAINTS AGAINST REGISTERED PERSONS; CLASS

16 ACTION SUITS.

17 Section 14(a) (7 U.S.C. 18(a)) (as amended by section
18 603(b) of this Act) is further amended—

19 (1) by redesignating paragraphs (1) and (2) as
20 subparagraphs (A) and (B), respectively;

21 (2) by inserting “(1)” after the subsection des-
22 ignation; and

23 (3) by adding at the end the following new
24 paragraph:

1 “(2)(A) An action may be brought under this subsec-
2 tion by any one or more persons described in this subsec-
3 tion for and in behalf of such person or persons and other
4 persons similarly situated, if the Commission permits such
5 actions pursuant to a final rule issued by the Commission.

6 “(B) Not later than 270 days after the date of enact-
7 ment of this paragraph, the Commission shall propose and
8 publish for public comment such rules as are necessary to
9 carry out subparagraph (A). In developing such rules, the
10 Commission shall consider the potential impact of such ac-
11 tions on resources available to the reparations system es-
12 tablished under this Act and the relative merits of bringing
13 such actions in Federal court.”.

14 **SEC. 610. PENALTIES STUDY AND GUIDELINES.**

15 (a) **STUDY.**—The Commodity Futures Trading Com-
16 mission shall study the penalties the Commission imposes
17 against persons found to have violated the Commodity Ex-
18 change Act (7 U.S.C. 1 et seq.) and the penalties imposed
19 by contract markets against persons found to have violated
20 their respective rules established under such Act.

21 (b) **REPORT.**—Not later than 2 years after the date of
22 enactment of this Act, the Commission shall submit to the
23 Committee on Agriculture of the House of Representatives
24 and the Committee on Agriculture, Nutrition, and Forestry

1 of the Senate a report that describes the results of the study
2 conducted under subsection (a). The report shall—

3 (1) include an analysis of whether systematic
4 differences exist among penalties imposed by various
5 contract markets for similar offenses, and, if so, the
6 causes of such differences;

7 (2) propose industry-wide guidelines or rules to
8 make penalty levels among exchanges consistent, in-
9 cluding, if appropriate, minimum penalties or penalty
10 ranges for various offenses; and

11 (3) propose guidelines or rules to make Com-
12 mission penalty levels consistent, including, if appro-
13 priate, minimum penalties or penalty ranges for vari-
14 ous offenses.

15 TITLE VII—ASSISTANCE TO FOREIGN 16 FUTURES AUTHORITIES

17 SEC. 701. DEFINITION OF FOREIGN FUTURES AUTHORITY.

18 Section 2(a)(1)(A) (7 U.S.C. 2, 4) (as amended by
19 section 501 of this Act) is further amended by adding at
20 the end the following new sentence: "The term 'foreign
21 futures authority' means any foreign government, or any
22 department, agency, governmental body, or regulatory or-
23 ganization empowered by a foreign government to admin-
24 ister or enforce a law, rule, or regulation as it relates to a
25 futures or options matter, or any department or agency of a

1 political subdivision of a foreign government empowered
2 to administer or enforce a law, rule, or regulation as it
3 relates to a futures or options matter.”.

4 SEC. 702. SUBPOENA AUTHORITY.

5 The third sentence of section 6(b) (7 U.S.C. 15) is
6 amended—

7 (1) by striking “Act and” and inserting
8 “Act,”; and

9 (2) by striking “Act,” and inserting “Act, and
10 for the purpose of any action taken under section
11 12(g),”.

12 SEC. 703. DISCLOSURE BY THE COMMISSION OF INFORMATION RE-
13 CEIVED FROM FOREIGN FUTURES AUTHORITIES.

14 Section 8(b) (7 U.S.C. 12(b)) is amended by adding at
15 the end the following new sentence: “Nothing in this sub-
16 section shall apply to the disclosure of data or information
17 obtained by the Commission from a foreign futures author-
18 ity.”.

19 SEC. 704. DISCLOSURE BY THE COMMISSION OF INFORMATION TO
20 FOREIGN FUTURES AUTHORITIES.

21 Section 8(e) (7 U.S.C. 12(e)) is amended—

22 (1) in the fifth sentence—

23 (A) by inserting after “jurisdiction,” the
24 first place it appears the following: “any for-
25 eign futures authority,”; and

1 (B) by inserting after "such" the follow-
2 ing: "foreign futures authority,"; and
3 (2) in the last sentence—

4 (A) by inserting after "information to a"
5 the following: "foreign futures authority or to
6 a";

7 (B) by inserting after "disclosed by such"
8 the following: "foreign futures authority,"; and

9 (C) by inserting after "or agency thereof"
10 the following: "or foreign futures authority".

11 SEC. 705. COOPERATION WITH FOREIGN FUTURES AUTHORITIES.

12 Section 12(a) (7 U.S.C. 16(a)) is amended by insert-
13 ing after "thereof," the following: "any foreign futures
14 authority, any department or agency of a foreign govern-
15 ment or political subdivision thereof,".

16 SEC. 706. INVESTIGATIVE ASSISTANCE TO FOREIGN FUTURES AU-
17 THORITIES.

18 Section 12 (7 U.S.C. 16) is amended by adding at the
19 end the following new subsection:

20 "(f)(1) On request from a foreign futures authority,
21 the Commission may, in its discretion, provide assistance
22 in accordance with this section if the requesting authority
23 states that the requesting authority is conducting an inves-
24 tigation that it considers necessary to determine whether
25 any person has violated, is violating, or is about to violate

1 any law, rule, or regulation relating to a futures or options
2 matter that the requesting authority administers or en-
3 forces.

4 “(2) The Commission may conduct such investiga-
5 tion as the Commission considers necessary to collect in-
6 formation and evidence pertinent to the request for assist-
7 ance.

8 “(3) Such assistance may be provided without regard
9 to whether the facts stated in the request would also consti-
10 tute a violation of a law of the United States.

11 “(4) In deciding whether to provide assistance under
12 this subsection, the Commission shall consider whether—

13 “(A) the requesting authority has agreed to pro-
14 vide reciprocal assistance to the Commission in fu-
15 tures and options matters; and

16 “(B) compliance with the request would preju-
17 dice the public interest of the United States.”.

18 **SEC. 707. PAYMENTS FROM FOREIGN FUTURES AUTHORITIES.**

19 Section 12 (7 U.S.C. 16) (as amended by section 706
20 of this Act) is further amended by adding at the end the
21 following new section:

22 “(g) Notwithstanding any other provision of law, the
23 Commission may accept payment and reimbursement, in
24 cash or in kind, from a foreign futures authority, or made
25 on behalf of such authority, for necessary expenses in-

1 curred by the Commission (including its members and em-
2 ployees) in carrying out any investigation conducted pur-
3 suant to this section or in providing any other assistance to
4 a foreign futures authority. Any payment or reimbursement
5 accepted under this subsection shall be considered a reim-
6 bursement to the appropriated funds of the Commission.”.

7 TITLE VIII—GENERAL PROVISIONS

8 SEC. 801. ETHICS TRAINING FOR REGISTRANTS.

9 (a) MANDATORY TRAINING FOR REGISTRANTS.—Sec-
10 tion 4p (7 U.S.C. 6p) is amended—

11 (1) by inserting “(a)” after the section designa-
12 tion; and

13 (2) by adding at the end the following new sub-
14 section:

15 “(b) The Commission shall issue regulations to re-
16 quire new registrants, within 6 months after receiving such
17 registration, to attend a training session, and all other reg-
18 istrants to attend periodic training sessions, to ensure that
19 registrants understand their responsibilities to the public
20 under this Act, including responsibilities to observe just
21 and equitable principles of trade, any rule or regulation of
22 the Commission, any rule of any appropriate contract
23 market, registered futures association, or other self-regula-
24 tory organization, or any other applicable Federal or State
25 law, rule, or regulation.”.

1 (b) REGULATIONS.—The Commodity Futures Trading
2 Commission shall issue the regulations required by section
3 4p(b) of the Commodity Exchange Act (as added by sub-
4 section (a) of this section) no later than 270 days after the
5 date of enactment of this Act.

6 SEC. 802. UNDERCOVER OPERATIONS AND ENFORCEMENT.

7 Section 8(a) (7 U.S.C. 12(a)) is amended—

8 (1) by designating the first and second sen-
9 tences as paragraphs (1) and (2), respectively; and

10 (2) by adding at the end the following new
-11 paragraph:

12 “(3)(A) Notwithstanding sections 2(a)(7) and 9(d) of
13 this Act, section 5945 of title 5, United States Code, sec-
14 tions 1341, 3302(b), and 9102 of title 31 of such Code, and
15 sections 254 and 255 of title 41 of such Code, the Com-
16 mission may, by order, authorize specified employees to
17 conduct undercover investigations where the Commission
18 has reason to believe that violations of this Act may have
19 occurred, may be occurring, or may be about to occur to
20 ascertain whether proceedings under this Act with respect
21 to such violations are appropriate.

22 “(B) The Commission shall notify the Attorney Gen-
23 eral and other appropriate Federal or State law enforce-
24 ment officials before initiating an investigation under this
25 paragraph. The Commission shall not adopt an order under

1 subparagraph (A) unless the Commission has first made a
2 request to the Attorney General that the Attorney General
3 conduct the proposed undercover investigation and the At-
4 torney General has declined to do so.

5 “(C) In conducting such investigations, the Commis-
6 sion may coordinate with and seek the assistance of other
7 Federal or State law enforcement authorities, contract mar-
8 kets, registrants, or other private parties as the Commission
9 considers appropriate.

10 “(D) During the conduct of an investigation under
11 this paragraph, the employees conducting such investiga-
12 tion shall report to the Chairman of the Commission no
13 less than once every 90 days on the progress of such inves-
14 tigation.

15 “(E) A Commission employee who participates in a
16 violation of this Act in the course and as a necessary ele-
17 ment of an undercover investigation authorized under this
18 paragraph shall not be liable in any action or proceeding
19 arising from such violation.

20 “(F) The Commission shall by rule adopt procedures
21 governing the conduct of such investigations that are simi-
22 lar to guidelines adopted by the Attorney General for the
23 conduct of undercover investigations.”.

1 SEC. 803. ACCESS BY GAO TO INFORMATION MAINTAINED BY
2 SELF-REGULATORY ORGANIZATIONS.

3 Section 8(i) (7 U.S.C. 12(i)) is amended—

4 (1) by inserting “(1)” after the subsection des-
5 ignation;

6 (2) by striking “, except” and all that follows
7 through the period at the end of the subsection and
8 inserting a period; and

9 (3) by adding at the end the following new
10 paragraphs:

11 “(2) For the purpose of conducting reviews and
12 audits under paragraph (1), the Comptroller General and
13 any duly authorized representative shall, under the terms
14 and conditions applicable to the Commission, have access
15 to and the right to examine all records and other recorded
16 information, in any form, and to examine any property that
17 is within the possession and control of any contract
18 market, clearinghouse, or registered futures association
19 within the jurisdiction of the Commission, or of a firm that
20 provides computer services to such self-regulatory organi-
21 zation or the Commission to the extent the records, infor-
22 mation or property relate to such computer services.

23 “(3) The Comptroller General shall maintain the
24 same level of confidentiality for information made avail-
25 able under this paragraph as the Commission. Officers and
26 employees of the General Accounting Office shall be sub-

1 ject to the same statutory penalties for unauthorized disclo-
2 sure or use as officers and employees of the Commission.

3 “(4) The Comptroller General shall not include in re-
4 ports data and information that would separately disclose
5 the business transactions or market positions of any person
6 and trade secrets or names of customers, although such
7 data shall be provided on request by any committee of
8 either House of Congress acting within the scope of its
9 jurisdiction.

10 “(5) The Comptroller General’s right of access under
11 this section shall be enforceable pursuant to section 716 of
12 title 31, United States Code.”.

13 **SEC. 804. ENHANCEMENT OF REGISTRATION REQUIREMENTS.**

14 (a) **INJUNCTIONS.**—Clause (ii) of section 8a(2)(C) (7
15 U.S.C. 12a(2)(C)(ii)) is amended to read as follows: “(ii)
16 engaging in or continuing any activity where such activity
17 involves embezzlement, theft, extortion, fraud, fraudulent
18 conversion, misappropriation of funds, securities or prop-
19 erty, forgery, counterfeiting, false pretenses, bribery, gam-
20 bling, or any transaction in or advice concerning contracts
21 of sale of a commodity for future delivery, concerning
22 matters subject to Commission regulation under section 4c
23 or 19, or concerning securities”.

24 (b) **CERTAIN VIOLATIONS OF LAW.**—Section
25 8a(2)(D)(iv) is amended—

1 (1) by inserting "1001," after "152,";

2 (2) by striking "or" after "1342,";

3 (3) by inserting "1503, 1623, 1961, 1962, 1963,
4 or 2314," after "1343,"; and

5 (4) by inserting ", or section 7201 or 7206 of
6 the Internal Revenue Code of 1986" after "Code".

7 (c) OTHER VIOLATIONS OF LAW.—Section 8a(2)(E) is
8 amended—

9 (1) by striking "by any court of competent ju-
10 risdiction," and inserting "in a proceeding
11 brought"; and

12 (2) in clause (i), by inserting "chapter 96 of
13 title 18 of the United States Code," after "1977,".

14 (d) REGISTRATION REVOCATION BASED ON INACCURATE
15 STATEMENTS.—Section 8a(2)(G) is amended—

16 (1) by striking "subparagraphs (A) through (F)
17 of this paragraph," and inserting "this paragraph
18 and paragraph (3),";

19 (2) by striking "material" the first place it ap-
20 pears and inserting "materially"; and

21 (3) by striking "application" and inserting "ap-
22 plication or any update thereto".

23 (e) GENERAL FELONY CONVICTIONS.—Section 8a(3)(D)
24 is amended—

1 (1) by inserting "pleaded guilty to or" after
2 "person";

3 (2) by inserting a comma after "section" the
4 first place it appears;

5 (3) by striking "within ten years preceding the
6 filing of the application or at any time thereafter,";

7 (4) by striking ", including a felony"; and

8 (5) by striking ", more than" and inserting
9 "more than".

10 (f) SPECIAL FELONY CONVICTIONS.—Section 8a(3)(E)
11 is amended—

12 (1) by inserting "pleaded guilty to or" after
13 "person";

14 (2) by striking "within ten years preceding the
15 filing of the application for registration or at any
16 time thereafter"; and

17 (3) in clause (iv), by inserting ", or section
18 7203, 7204, 7205, or 7207 of the Internal Revenue
19 Code of 1986" after "Code".

20 (g) REGISTRATION DENIED OR CONDITIONED BASED ON
21 INACCURATE STATEMENTS.—Section 8a(3)(G) is amend-
22 ed—

23 (1) by striking "material" the first place it ap-
24 pears and inserting "materially";

25 (2) by striking the comma after "application";

1 (3) by inserting "or any update thereto," after
2 "application";

3 (4) by striking "thereunder, or" and inserting
4 "thereunder,"; and

5 (5) by inserting ", or in any registration dis-
6 qualification proceeding" after "before the Commis-
7 sion".

8 (h) NON-FEDERAL CRIMINAL CONDUCT.—Section
9 8a(3)(H) is amended by inserting ", in a United States
10 military court," after "State court".

11 (i) EXISTING RESTRICTIONS ON MEMBERSHIPS.—Section
12 8a(3)(J) is amended—

13 (1) by striking "or" after "association," the
14 first place it appears;

15 (2) by inserting "or any foreign regulatory body
16 that the Commission recognizes as having a compa-
17 rable regulatory program," after "organization," the
18 first place it appears;

19 (3) by striking "or" after "association," the
20 second place it appears; and

21 (4) striking "organization;" and inserting "or-
22 ganization, or foreign regulatory body;".

1 SEC. 805. HIRING AND COMPENSATION AUTHORITY OF COMMISS-
2 SION.

3 (a) IN GENERAL.—Section 12(b) (7 U.S.C. 16(b)) is
4 amended—

5 (1) by designating the first through third sen-
6 tences as paragraphs (1) through (3), respectively;
7 and

8 (2) by adding at the end the following:

9 “(4)(A) The Commission shall fix the compensation
10 and number of, and appoint and direct, employees of the
11 Commission. Rates of basic pay for employees of the
12 Commission may be set and adjusted by the Commission
13 without regard to the provisions of chapter 51, subchapters
14 III and VIII of chapter 53, and chapter 54 of title 5, United
15 States Code.

16 “(B) The Commission may provide additional com-
17 pensation and benefits to employees of the Commission if
18 the same type of compensation or benefits are then being
19 provided by any Federal bank regulatory agency or, if not
20 then being provided, could be provided by such an agency
21 under applicable provisions of law, rule, or regulation. In
22 setting and adjusting the total amount of compensation and
23 benefits for employees of the Commission, the Commis-
24 sion shall seek to maintain comparability with the Federal
25 bank regulatory agencies. For the purpose of this para-
26 graph, the term ‘Federal bank regulatory agency’ means

1 the Board of Governors of the Federal Reserve System, the
2 Office of the Comptroller of the Currency, the Federal De-
3 posit Insurance Corporation, the Office of Thrift Supervi-
4 sion, and the National Credit Union Administration
5 Board.".

6 (b) REGULATIONS.—The Commodity Futures Trading
7 Commission shall issue and submit to Congress proposed
8 regulations to carry out the amendment made by subsec-
9 tion (a) of this section.

10 (c) EFFECTIVE DATE.—Such amendment and regula-
11 tions shall become effective 30 legislative days or 90 cal-
12 endar days, whichever is later, after submission of such
13 regulations to Congress.

14 SEC. 806. SERVICE FEES.

15 (a) IN GENERAL.—Section 12 (7 U.S.C. 16) (as
16 amended by sections 706 and 707 of this Act) is further
17 amended by adding at the end the following new subsec-
18 tion:

19 "(h)(1) Notwithstanding any other provision of law,
20 the Commission shall promulgate, after notice and oppor-
21 tunity for hearing, a schedule of appropriate fees to be
22 charged for services rendered and activities and functions
23 performed by the Commission in conjunction with its ad-
24 ministration and enforcement of this Act.

1 “(2) Such fees shall reflect the cost to the Commis-
2 sion of—

3 “(A) monitoring—trading on the floors of desig-
4 nated contract markets to prevent and deter viola-
5 tions of this Act;

6 “(B) supervising contract markets, futures asso-
7 ciations, leverage transaction merchants, and other
8 registrants to ensure compliance with self-regulatory
9 standards established under this Act;

10 “(C) analyzing and designating new futures,
11 option, or leverage contracts; and

12 “(D) such other services, activities, and func-
13 tions as the Commission finds appropriate for such
14 fees.

15 “(3) In promulgating a schedule of appropriate fees
16 under this subsection to be assessed against persons bene-
17 fiting from services rendered or activities performed by the
18 Commission, the Commission may consider phasing in any
19 new or increased fees. In making such determination, the
20 Commission shall consider (A) the immediate impact on
21 the Federal budget of increasing the size and scope of the
22 Commission, and (B) the burden of other reasonable costs
23 being borne by such persons for purposes of such persons
24 coming into compliance with the standards of section
25 5a(13).”.

1 (b) CONFORMING AMENDMENT.—Section 26 of the Fu-
2 tures Trading Act of 1978 (7 U.S.C. 16a) is repealed.

3 **SEC. 807. APPEALS BY REGISTERED FUTURES ASSOCIATIONS.**

4 Section 17(i)(4) (7 U.S.C. 21(i)(4)) is amended by
5 striking “(other than a registered futures association)”.

6 **SEC. 808. TELEMARKETING FRAUD.**

7 Section 17 (7 U.S.C. 21) is amended by adding at the
8 end the following new subsection:

9 “(r) Each futures association registered under this
10 section shall, subject to the approval of the Commission
11 pursuant to subsection (j), adopt a rule specifying the fac-
12 tors it will consider in determining whether to issue a sum-
13 mary member responsibility action or other disciplinary
14 action to require a member to adopt special supervisory
15 procedures relating to telephone solicitations for new fu-
16 tures or options customer accounts. Such procedures shall
17 require at a minimum that, with respect to an individual
18 with no previous futures or options trading experience who
19 was solicited by telephone, the member may not enter any
20 order for such individual for a period of not less than 3
21 days after the individual signs the required acknowledg-
22 ment of receipt of the applicable risk disclosure state-
23 ment.”.

1 SEC. 809. VENUE; SERVICE OF PROCESS.

2 Section 22(c) (7 U.S.C. 25(c)) is amended by adding
3 at the end the following new sentences: "Any action
4 brought under subsection (a) may be brought in any dis-
5 trict in which the defendant is found or is an inhabitant or
6 transacts business, or in the district in which any act or
7 transaction constituting the violation occurred. Process in
8 such action may be served in any district of which the
9 defendant is an inhabitant or wherever the defendant may
10 be found."

11 SEC. 810. STUDY OF DELIVERY POINTS FOR AGRICULTURAL COM-
12 MODITY CONTRACTS.

13 (a) STUDY.—The Comptroller General of the United
14 States shall conduct a study of the provision for, and func-
15 tioning of, delivery points regarding contracts of sale for
16 future delivery of any agricultural commodity to determine
17 whether the objectives of section 5a(10) of the Commodity
18 Exchange Act (7 U.S.C. 7a(10)) are being achieved. The
19 study shall also examine—

20 (1) whether the objectives of such Act relative
21 to such delivery points need to be revised;

22 (2) whether the availability and adequacy of
23 storage facilities for agricultural commodities at such
24 delivery points affect prices;

25 (3) whether the number, accessibility, and
26 volume of storage facilities at such delivery points

1 contribute to consistency and reasonableness in price
2 discovery in the contract market;

3 (4) whether a system of delivery in cash under
4 such contracts of sale for future delivery would be
5 feasible and would further the public interest in
6 hedging and price basing for agricultural commod-
7 ities;

8 (5) whether special concerns about the adequacy
9 of delivery are raised by the participation in such
10 contracts of international corporations whose com-
11 mercial needs for physical commodities may be
12 global; and

13 (6) such other issues relating to such delivery
14 points as the Comptroller General determines rele-
15 vant to the efficient operation and improvement of
16 contract markets for agricultural commodities.

17 (b) REPORT.—Not later than 1 year after the date of
18 enactment of this Act, the Comptroller General shall
19 submit to the Committee on Agriculture of the House of
20 Representatives and the Committee on Agriculture, Nutri-
21 tion, and Forestry of the Senate a report containing the
22 results of the study conducted under subsection (a), togeth-
23 er with any appropriate recommendations.

TITLE IX—EFFECTIVE DATE

1

2 **SEC. 901. EFFECTIVE DATE.**

3

4 Except as otherwise provided in this Act, this Act and
5 the amendments made by this Act shall become effective
on the date of enactment of this Act.

APPENDIX 5

All futures contracts traded on the Board of Trade are subject to the Board of Directors' emergency powers. CBOT Rule 180.00(c). CBOT Rule 180.00 and Regulation 170.02 describe the authority of the Board of Directors to address a market emergency. These rules have been approved by the CFTC and are authorized by CFTC Regulation 1.41(f).

In the case of expiring futures contracts, a request for emergency action can be brought to the Chairman of the Board by the Business Conduct Committee, which is responsible for monitoring contract expirations and detecting evidence of congestion, disorderly liquidation, and other unusual or suspicious activity. It is Exchange policy to coordinate its surveillance efforts with the CFTC, and to keep the CFTC apprised of its concerns and actions. Obviously, a request for emergency action calls for the Board's immediate attention and may not coincide with the Board's regular monthly meeting.

CBOT Rule 127.00 provides that the Chairman may, or upon the written request of five Directors the Secretary shall, call a special Board meeting. Because the information regarding potential emergency action is extremely sensitive, it is brought to the attention of the Chairman confidentially. As a matter of practice, he (and not the Secretary) would call a special Board meeting to consider emergency action.

Special Board meetings may be called for any reason, including the consideration of emergency action. Rule 127.00 requires the Secretary to give at least one hour notice of a special Board meeting. Such notice is usually posted on the Exchange Floor Bulletin Board (the "Announcement on Change" called for by our rules) and supplemented by a telephonic or written "call" to the member directors. The three public Directors, who are not members of the Exchange, may be notified earlier to assure their availability.

In the case of a special Board meeting called to consider emergency action, Exchange practice is to adhere as closely as possible to the minimum one hour advance notice requirement and to inform as few Directors as possible of the meeting before the notice is posted. Also, as a matter of Exchange policy, special Board meetings are scheduled outside of trading hours and any notice of emergency action is made public before trading resumes to avoid disruptions in the market.

Rule 127.00 limits the business that may be considered at a special Board meeting to "that embraced in the call." As this language implies, the "call," or notice of the meeting to the Directors, must describe the matter(s) to be considered at the meeting. Such descriptions are general so as not to disclose any

market-sensitive information. It has also been the practice of the Exchange to give the CFTC prior notice of a special Board meeting at which emergency action will be considered.

To take emergency action under Rule 180.00, a quorum of the Board must be deemed present and at least one third of the Board must be physically present. Under Rule 125.00, a quorum consists of twelve Directors (there are a total of twenty-four Directors (Rule 120.00)), and under Regulation 125.01, a Director who is not physically present may be deemed present if the Director is in continuous communication (*i.e.*, by telephone) with the other directors who are deemed present.

At the beginning of a special Board meeting to consider emergency action relating to expiring contracts, it is Exchange policy for the Chairman to poll each Director who is present to determine whether the Director owns or controls any position in the relevant contract. If a Director discloses that he or she owns or controls any positions in the relevant contract, the Director will be asked to recuse himself or herself.

After it has been determined that quorum of disinterested Directors is present, the Board is presented with materials and information relating to the expiring contract in question. It is Exchange policy that the Board should be provided with as much information as is necessary to make an informed decision. However, market participant identities are not revealed to the Board and every effort is made to minimize disclosure of the specific positions of individual market participants. Names of market participants are redacted from written materials provided to the Board. The handful of Exchange staff and Counsel who know these identities do not identify market participants to the Directors.

As a matter of practice, the Board determines whether the basis for emergency action exists, and, if so, whether to take action and what action to take. The Board's deliberations are subject to the strictest confidence. CBOT Regulation 188.01 bars a Director from knowingly using or disclosing any material, non-public information obtained as a result of his participation on the Board for any purpose other than the performance of his official duties as a Director. The decision to adopt an emergency Regulation or Resolution must be approved by two-thirds of the Directors voting where a quorum is deemed present and at least one-third of the Directors are physically present.

Immediately after the Board adopts an emergency Resolution or Regulation, Exchange staff and counsel prepare the document setting forth the emergency action. The document is presented to, reviewed, approved and executed by the Chairman and delivered to the Secretary. The Secretary promptly posts the notice required by Rule 180.00 on the floor of the Exchange and transmits the notice required by CFTC Regulation 1.41(f)(2) to the CFTC's Washington office by the most rapid means available, generally

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telecopy. In addition, the CFTC is notified by phone. Section 5a(8) of the Commodity Exchange Act requires the Exchange to enforce its rules. Accordingly, the exchange promptly investigates all allegations that a Director has misstated his interest in a contract when polled by the Chairman or that a Director has used or disclosed material non-public information in violation of CBOT Regulation 188.01.

Senator HARKIN. Thank you, Mr. Mahlmann.
Mr. Melamed.

STATEMENT OF LEO MELAMED, CHAIRMAN OF THE EXECUTIVE COMMITTEE AND SPECIAL COUNSEL TO THE BOARD, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL

Mr. MELAMED. Thank you, Mr. Chairman, Senator Lugar, Senator Boschwitz, members of this committee. I will submit my long and specific written statement for the record and only make a brief opening statement at this time.

CONCERNED ABOUT THE LEGISLATION

Gentlemen of this committee, the circumstances surrounding this legislation developed during the most difficult time in futures history. The Federal investigation of our markets cast a long and disturbing shadow on our industry.

This was exacerbated by a media penchant to sensationalize some of these wrongdoings.

This legislation is being developed during a period in which there might be an overreaction. That overreaction may do great damage to a national resource—the markets we represent.

I CAN ASSURE YOU THAT WE FEEL AS STRONGLY AS YOU IN OUR DESIRE TO STAMP OUT ANY AND ALL WRONGDOING

Mr. Chairman and members of this committee, I can assure you that we feel as strongly as you in our desire to stamp out any and all wrongdoing. We have proceeded to institute those rules and those necessary elements to do that. But these things must be put into perspective. It must be remembered that the alleged wrongdoing to customers is diminishingly small compared to the value of services performed.

It must also be remembered that the latest and best estimate available indicates that the cost of the alleged fraud is less than one ten-thousandth of a percent of the overall value of the services honestly performed by these markets. And while we agree that even one wrongdoing is one wrongdoing too many, and while we agree that we must do everything in an uncompromising fashion to preserve our integrity of these markets, we cannot do it without understanding the fact that we are in a competitive world where foreign competition is no idle threat.

FOREIGN COMPETITION IS NO ILLUSION

In an era of satellite communication, of fiber optics and microchips, such foreign competition is no illusion. Our markets are the envy of the rest of the world, and with good reason. Our markets provide an indispensable risk management tool, one that every financial center in the world would like to have. These markets act as an economic engine to the countries in which they reside.

Since the Chicago Mercantile Exchange launched the financial revolution back in 1972, our markets at the Chicago Mercantile Exchange have increased in volume by 38,000 percent. That's in only 16 years. Small wonder that these markets have now been announced or created in London, Paris, Hong Kong, Sydney, Toronto,

Singapore, New Zealand, Brazil, Zurich, Dublin, Frankfurt, Osaka and Tokyo. And it is small wonder they want what we have. Not all our foreign competitors are necessarily playing fair.

AN "AFTER-HOURS" ELECTRONIC TRANSACTION SYSTEM

It was those same pioneers, Mr. Chairman, that launched the financial revolution back in 1972 who 2 years ago, to the surprise of most in our industry (as well as in our Congress), announced the development of an "after-hours" electronic transaction system.

That idea did not come from Congress. That idea came from the same people in our marketplace that thought that the only way we could compete in the coming era of internationalization and globalization is through GLOBEX, the after-hour electronic automated system we created with Reuters.

THE WORLD IS NOT NECESSARILY INTERESTED IN ALLOWING US TO COMPETE IN THAT FASHION

But the world is not necessarily interested in allowing us to compete in that fashion. And while Great Britain has already approved the GLOBEX idea, and France and Switzerland are about to (we're told), we are not necessarily getting a favorable response from Japan, where the greatest danger of competition lies. So far, our pleas to Japan and its Ministry of Finance to approve GLOBEX—and there is no substantive economic or rational reason not to approve it—have gone unanswered.

LEGISLATION THAT IMPEDES OUR MARKETS WILL SERVE OUR COMPETITORS

In an era such as we live where the competition is what it is, where our markets can go anywhere at any time, where GLOBEX represents the vanguard of the financial services arena, where the CME is negotiating with the Chicago Board of Trade to unify two systems (GLOBEX and Aurora) into one strong American-based system, we fear that legislation that impedes our markets at this moment in time will serve our competitors. And this is no idle threat, gentlemen of this committee.

We implore that you assist us in maintaining this national resource, one that we have created through the ingenuity of our private sector. We ask that you help us in preserving the integrity of these markets, as you should and we should, but not in a fashion that impedes our international standing in the competitive world of markets.

Thank you.

[The prepared statement and attachments of Mr. Melamed follow:]

TESTIMONY
OF
LEO MELAMED
CHAIRMAN OF THE EXECUTIVE COMMITTEE
AND SPECIAL COUNSEL TO THE BOARD
CHICAGO MERCANTILE EXCHANGE
BEFORE THE
U.S. SENATE
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
OCTOBER 17, 1989

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* * *

Mr. Chairman, my name is Leo Melamed. I am Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME). Thank you for this opportunity to offer comments on the Futures Trading Practices Act of 1989 (the "Bill").

Mr. Chairman, we are greatly concerned about this Bill. We understand that the circumstances surrounding the development of the Bill were among the most difficult periods in the history of the futures industry. The Federal investigation cast a disturbing shadow on our reputation.

The media's penchant to sensationalize slighted two key issues. First, the investigation related to a very small number of our members. The vast majority of our members are rule-abiding and not suspect. Second, the cost of the alleged wrongdoing to public customers is diminishingly small compared with either the value of the services performed for such customers or the value of the contracts traded. The latest and best estimate available to me is that the cost of the alleged fraud is less than one ten-thousandth of a percent of the overall value of services honestly performed.

It should be noted that the institutions themselves are not a target. What better proof of the futures industry's importance than the testimony of our customers, who were fully informed of all of the allegations, who increased their use of CME to the extent that the Exchange's 1989 transaction volume is up 38 percent over 1988.

We do not condone violators, we condemn them. We can improve our trade practice surveillance. We must not and will not tolerate any rule infraction that jeopardizes our public customers. We have passed a comprehensive set of trading rule improvements. We

launched the development of state-of-the-art technological enhancements in order to make our transaction process the safest, most modern and most efficient in the world. A summary of those changes, "Summary of Trading Rule Enhancements," adopted by the CME Board of Governors on August 2, 1989, and cover letter to the membership are attached hereto as Exhibit A.

Mr. Chairman, we are greatly concerned about this Bill because it fails to recognize the steps the futures industry has taken. I assure you that both the CME and the Bill's sponsors share the same basic goal: we both want to insure the integrity of our markets and bolster public confidence in that integrity. That fundamental goal can be, and must be, pursued in light of the need to maintain efficient and competitive markets.

As this Committee well knows, the U.S. futures industry is not immune from the challenge of foreign competition. If U.S. futures markets cease to efficiently perform their risk transference function, both domestic over-the-counter markets and off-shore futures markets will immediately fill the void. Neither of those competitors is subject to comparable regulation.

The challenge of this industry -- and of this Committee -- is to resolve concerns about the industry's ability to detect and prosecute customer abuse so as to enhance, not enfeeble, this industry. The reports of undercover investigations in Chicago and New York impose tremendous pressures on all of us to take some dramatic action. We know that the industry is prepared to act and that our response will be both timely and effective.

We differ with the approach of the proposed Bill because we do not find the need for Congress to modify its well-proved policy of requiring effective self-regulation subject to oversight by the Commodity Futures Trading Commission (CFTC).

The term "self-regulation" as applied to futures exchanges gives a misleading impression respecting the independence of the industry from government supervision. The Commodity Exchange Act grants the CFTC extensive power over the futures industry. The exchanges cannot adopt or amend any substantive rule (with the salient exception of margins) without approval of the federal regulator.

If the CFTC is not satisfied with the rules in force, it has the power (which it has exercised), to force the exchanges to adopt rules that the Commission deems necessary. This Bill attempts to add yet another level of difficulty in the effectiveness and efficiency of the rule-making process. It is an attempt to micro-manage the industry by Congressional edict.

We do not believe that an industry as complicated and cost sensitive as the futures industry can be effectively managed by Congress at the level of detail proposed by the Bill.

Allow me to offer several examples of situations where the industry's goals are the same as this Committee's, yet the Bill's attempts to impose detailed solutions create difficulties greater than the problems being addressed.

AUDIT TRAIL

The Bill mandates a perfect audit trail. We can conceive of a way to restructure the industry to meet that standard, but at what cost? There are three significant types of costs to consider: (1) costs to the institution to design, implement, and secure compliance with the system; (2) costs to the customers arising out of any decreases in efficiency in the market or increase in costs from brokers subject to additional costs by the new system; and (3) costs to the nation caused by the diversion of business to offshore exchanges that employ more efficient trading systems.

The important issue here is not merely whether you can achieve an abstractly perfect audit trail. It is fair and correct to ask what violations will be detected under the Bill's audit trail which would not be detected and punished under the CME's improved audit trail. The cost of the undetected violations must then be weighed against the full cost of the changes necessary to move from the systems proposed by the exchanges to the systems mandated by the Bill.

We can perfect a surveillance and punishment system that is highly effective in detecting and deterring trading abuses on the Exchange floor. Surely you are all aware that no amount of money, effort or good faith can deter, discover and punish each and every rule violation.

While we have not absolutely prevented our members from violating our rules or the law, during 1987 and 1988 the CME opened 260 trade practice investigations and secured convictions of 188 individuals. A large portion of these investigations and prosecutions were a direct result of information provided by our internal computerized surveillance system and floor monitors (23%) and by information provided by member and non-member informants (77%).

The fines imposed by the CME for such trade practice prosecutions since January 1, 1987 total approximately \$4 million. By contrast, the FBI investigation that encompassed two years has thus far resulted in 23 indictments of CME traders, and potential wrongdoing is

estimated at \$300,000 to \$500,000. The conclusion is clear. There was no major flaw in the CME's surveillance system, and the investigation and subsequent work at the CME will remedy the lacunae revealed by the FBI probe.

The proposed audit trail language in the Bill [Sec. 201, proposing a new 5a(13)(A), (B), and (C)] is reminiscent of an incident that occurred during the early days of the audit trail debate. One prominent regulator came to observe the trading pits so he could suggest improvements to our audit trail. He watched for several hours. He agreed that the heavy order flow during periods of highest volatility made it impossible for the broker to accurately time record every trade while he executed the orders in a manner which served the best interests of his customer. The regulator had a categorical solution: "Slow down the trading."

He was correct. If we had imposed a limit on the speed at which we allowed prices to move and the number of executions that could be done each period, we could have achieved a perfect audit trail. Of course, in such a case, perfection would be achieved at the cost of destruction of the market and its universally acknowledged benefits.

Our markets have been extraordinarily successful because the advice of that regulator was rejected. Instead, Congress decided to set standards of performance rather than attempt to substitute its business judgment for that of experienced managers and experts on the intricacies of the futures markets. The consequence of that long-standing legislative decision is a successful and useful industry that is centered in the United States.

Now, however, we see a Bill with a different approach: not performance standards, but a micro-managed audit trail. Indeed, we are faced with a Bill mandating results that are not technologically achievable. Proposed section (13)(B) requires that each exchange create an audit trail system that accurately records the sequence of trades for each floor broker. This standard must be met immediately upon the effective date of the Bill. That standard, which is unnecessary for the purpose of detecting and deterring violations, cannot be achieved with existing technology. Each market in which there is substantial volume will be out of compliance and subject to the enormous penalties that the Bill seeks to attach to exchange noncompliance.

A floor broker filling a thousand contract order will trade opposite a large number of brokers and traders in a very short period of time. The broker does not have the luxury of pausing during the process of filling the

order in order to keep chronological track of whether he filled the first 50 contracts opposite trader ABC or opposite trader DCE. The broker must continue to bid or offer until the order is filled and then write down the names of the opposite brokers. The chances are slim that he will record the names in the exact order in which he traded. Moreover, an audit trail accurate to the nearest minute does not always have the ability to portray the order of trades within that minute.

The Bill subjects the exchanges to horrendous penalties for its inability to provide a perfect sequence of a floor broker's trades and subjects that floor broker to criminal liability if the floor broker submits records that show the trades in an order that the floor broker knows to be less than perfectly accurate. Surely, this is not what this Committee intends.

On August 16, 1989, the CME and the Chicago Board of Trade announced plans to jointly develop a hand-held electronic audit terminal. Named AUDIT (Automated Data Input Terminal), the hand-held electronic recording device is intended to begin achieving a fully accurate and verifiable audit trail of all transactions by tracking the times that every trade enters and is executed in each pit. AUDIT is central to a proposed state-of-the-art electronic audit trail system which will eventually include stationary broker terminals. Each exchange has pledged an initial investment of \$5 million toward development of the AUDIT terminals.

Past studies regarding such systems repeatedly revealed a lack of the proper technology to meet the industry's requirements. It is for this reason that the joint decision to research and co-develop the system was made. Research will focus on keyboard technology and technology allowing transmission of information from hand-held terminals to exchange-operated central computers and clearing houses.

Our goal is to have this uniquely engineered device constructed, tested and implemented within a short time frame. This is a serious commitment. It is a commitment of great resources. A commitment that will in fact achieve an extraordinary audit trail, sufficient to detect and deter violations.

However, the specific legislative language in the Bill relating to these matters is vague. It does not make it clear whether our attainment of AUDIT and its intended objectives is what is sought or will suffice. Moreover, the nebulous nature of the legislative language is pervasive, making it difficult to know what is required.

What, for instance, is meant by a "source independent" of the person making a trade? Will the exchange suffice as such an independent source? Will the AUDIT terminal? And what does "continually recorded in the record of the contract market" mean? Does that mean that pit transaction record must be electronically transmitted to the exchanges audit trail record? Does it allow for the use of diskettes or other electromagnetic records? Can we use electromagnetic recording devices if technology exists to overwrite those records? Does it mean the current system of hand-written cards, but perhaps in a form of indelible ink?

These are but examples of some highly relevant but unanswered questions that are flagged by the legislative language of the Bill. They represent compelling rationale why we object to any attempt to micro-manage complex and difficult issues by virtue of Congressional enactment. While our goal and your goal is the same, we feel that the approach is wrong.

Further, the Bill's proposed Sec. 5a (13)(A) sets forth a clear sweeping goal, making fair and appropriate demands on the futures industry. However, provisions (B) and (C) again enter into micro-management, mandating standards difficult to understand and not achievable today. And yet the Bill provides that if we fail to achieve "such standards," penalties would be imposed of \$500,000 per day. It is difficult to know how the smaller Exchanges will survive such radical measures when the large Exchanges will soon be out of business as a result.

Another suspicion we harbor is that the underlying motivation for these proposals is to bring a quick end to the open outcry system. If true, we caution this Committee against taking so draconian and dangerous an approach. While open outcry has many failings and is far from perfect, its special qualities have operated to make our markets the most liquid in the world. Other countries have attempted to emulate this system because of this very result. Furthermore, and please forgive us for this analogy, but most experts agree that the specialist system in securities markets is also far from perfect, yet we have not heard about Congressional action to do away with it, nor is it the business of government to make such a determination.

The alternative, we believe, that is intended to be furthered by this proposal is electronic trading. If so, we are a bit surprised. To set the record straight it was not the Congress but the futures industry itself, specifically the Chicago Mercantile Exchange -- the same pioneer who conceived the financial futures revolution in 1972 -- which two years ago startled the world by announcing yet another revolutionary idea. On September

2, 1987, in a far-reaching joint undertaking, the CME and Reuters Holdings PLC entered into a long-range agreement to create GLOBEX, a global electronic automated transaction system for the trading of futures and futures-options. At the time, we had to go about convincing the world as well as members of this very Committee that our idea was meritorious.

Clearly, the CME is in the forefront of electronic system development. Clearly, the CME is in favor of technological enhancement to the transaction process. Clearly, we are spending large sums of money and energy on its behalf. Indeed, we devote a large portion of every business day furthering the GLOBEX concept and in an attempt to convince other Exchanges to join us. But at no time did we contemplate that our proposed electronic trading concept could be launched or could succeed without the liquidity engine of open outcry behind it. At no time did we contemplate that GLOBEX would act as the replacement to the present system.

We have some very important additional points to make about GLOBEX later in this testimony, but allow us to make this further point now. While no one can predict the long run consequences of automation on the open outcry system, the CME knew that prudence dictated a conservative approach. We chose the only responsible route. Namely, to develop an automated electronic system in conjunction with open outcry in a manner whereby the futures industry could benefit from both systems. Such an approach would allow a normal evolutionary process to dictate the ultimate result. We rejected and continue to reject any attempt to artificially force one transaction methodology over the other.

Instead of directing the type of transaction process our industry should utilize or attempting to micro-manage our industry by legislation, we believe that goals should be established requiring each exchange to improve its surveillance and compliance systems in order to detect and punish trading abuses. Such an approach will achieve the stated purposes of this legislation. We believe it should be within the purview of each exchange in conjunction with the CFTC to determine which form such enhancements must take. In this respect, we strongly recommend adoption of the CME's CTR system for purposes of improving the verifiable accuracy of trade timing in order to reach the standard required.

The CME's internal review committees have recommended the following enhancements to our audit trail and surveillance systems:

- Report matched trade information on the trading floor for self-policing purposes. In addition to

the information recommended to be displayed by the Special Committee, the CME review committee also recommended that customer-type indicator and order-type indicator information be included.

- Establish additional audit trail requirements so that verbal orders may be more accurately timed.
- Increase floor surveillance staff to provide greater coverage of all trading areas, particularly during market openings and closes and during periods of unusually active or volatile markets.
- Authorize additional investigative compliance staff.
- Conduct a study of the effectiveness of camera surveillance for specific trading practice investigations on the trading floor.
- Enhance the trade information database to assist staff review of out-trades.
- Institute opening and closing bracket indicators to distinguish trades occurring during these brief and active periods from other trades which occur during the first and last half-hours of trading.
- Require the pick-up of trading cards from members every two hours. If audit trail improvement goals are not met within six months, require that trading cards be picked up on an hourly basis. Currently, trading cards are collected twice daily.
- Implement 15-minute bracket periods. Currently, bracket periods last 30 minutes.
- Require uniform time-stamping of customer orders by clearing firms.
- Require floor brokers and traders to designate spread trades.
- In order to improve trade timing, require that order-type information be submitted for all customer orders.

SERVICE FEES

We are particularly concerned by the Service Fee provision which seems to grant the CFTC power to impose a tax on futures trading that could be as high as \$60,000,000 per year.

While the Bill requires the Commission to consider the new costs being incurred by the exchanges to improve

their audit trails, it does not consider past investments, continuing expenses to conduct the audit and surveillance program, or the major commitment of the industry to fund the National Futures Association (NFA).

Six years ago, we reached an understanding with this Committee respecting the creation of the NFA. The industry agreed to create, support and fund a self-regulatory organization that would relieve the Commission of a great deal of administrative and regulatory burden. Most importantly, we agreed to fund the NFA ourselves rather than imposing any additional burdens on the budget. We were good to our word.

The NFA's accomplishments are well known and widely approved with respect to: developing and enforcing customer protection rules; providing education respecting the risks of futures trading and unscrupulous operators; providing a well-used arbitration forum; and barring unethical operators from the industry.

None of this was cheap, nor did we expect it to be. The NFA's budget currently stands at \$25 million. No part of this comes from the federal government. The industry fully performed its side of the bargain. We do not understand the impetus for the proposed service fees against the background of the understanding that we had forged with this Committee.

CONFLICT OF INTEREST

Title IV of the Bill, "Governing Structure," effectively precludes membership organizations from operating as futures exchanges. Section 401 precludes a member of the Board from voting or deliberating on any "issue" as to which he or any person with whom he is affiliated is "a specific and actual party in interest..."

The Bill does not take account of the fact that futures exchanges are membership organizations and that the members of the governing boards are members of the institutions. Each member of the board has a "specific" interest in almost every issue that comes before the board.

For example, a member of the CME who specializes in agriculture futures favors a shift of the advertising budget to farm-related publications. This is at the expense of spending in the Financial Times and those members who trade financial instruments. A gold trader wants to promote that contract at the expense of adding space to the Eurodollar pit. There is no issue of any importance that could be voted on by a member of the institution.

The Commodity Exchange Act currently recognizes this inevitable feature of membership organizations. No significant rule can become effective until it has been submitted for review to the CFTC. All rules that have significant economic consequences are published for public comment before they can become effective. We are not a secret society. Everything we do that is of any significance is exposed to public view and subject to agency scrutiny before it becomes effective. No further check or balance has been demonstrated to be necessary. This major restructuring of an industry is not justified by any failure of management and it is without parallel in the securities industry.

The CME, with the CFTC's approval has implemented a detailed and workable set of regulations to avoid conflicts of interest. The CME employs highly restrictive procedures if it is acting in an emergency, where its action is not subject to prior review by the CFTC. It employs the standard corporate conflict rules where its actions are subject to prior CFTC review. In addition, all Board members and members of sensitive committees sign pledges to preserve the confidentiality of information learned in the course of their duties and to refrain from any use of confidential information.

GOVERNING BOARDS

Our Exchange has always enlisted public and industry governors to serve on our Board. This was the result of our judgment that this is an advisable business practice. The composition of an exchange governing board is a business decision that exchanges arrive at for competitive reasons.

We believe this is another area that should be left to the discretion of the individual exchanges. It is not appropriate in this context for Congress to substitute its business judgment for the judgment of the institutions that are actually competing. Nor is it appropriate to impose the additional cost associated with this action. Nor is there any securities law parallel.

GOVERNMENT ACCOUNTING OFFICE ACCESS TO
EXCHANGE INFORMATION

Presently, the CFTC has full access to any and all materials in the possession of the Exchange and clearing house.

However, this Bill [Sec. 803 "Access by GAO to Information Maintained by Self-Regulatory Organizations"] would not only grant that authority to the GAO, but further expand that authority, granting GAO access to all records and information of firms that provide computer services to the Exchange.

These provisions are unnecessary and would impose extraordinary costs on exchanges. The approach appears to denigrate the integrity of the CFTC and imposes duplicative costs on the Federal government at a time of great need for budgetary restraint.

This proposal gives the GAO and CFTC duplicate authority. While the GAO may wish to conduct investigations and appropriately review exchange procedures, there is no reason for them to have access to position or volume data in order to appropriately accomplish that analysis.

Further, costs would soar because computer vendors would be extremely cautious about providing any services to exchanges, recognizing that their services, software and technological secrets would all be subject to GAO scrutiny and potential disclosure to any congressional committee that sought the information.

We are particularly bothered by this provision because of GLOBEX and our contractual relationship with Reuters PLC as a provider of computer services. Reuters' services to us are so highly developed as a trade and business secret that Reuters will not even provide the information to us. This is a highly competitive world, and no innovator wishes to have his technological secrets handed over to the Federal government for any congressional committee that might want them. We believe these provisions are ill thought-out. They should be stricken or severe competitive damage would occur to the United States.

DEFINITION OF DUAL TRADING

The Bill's "Definition of Dual Trading" is another example of attempting to legislate in a highly complicated area that is best left to the independent agency with expertise.

For example, the proposed statutory definition is well intended, seeking to prohibit anyone who has seen the

customer order flow as a broker from then being able to turn around that same day and trade for his own account.

However, the statutory definition does not allow for a situation where a trader, trading for his own account, who has not seen any order data might at some point later in the day choose to become a broker in order to facilitate unanticipated volume demands.

While it is arguable that a broker who has seen customer orders may achieve some benefit at the expense of customers by shifting to being a trader, a shift in the other direction -- from trader to broker -- causes no harm, and may indeed facilitate customer needs. This is a matter that could be better left to the CFTC to develop in rule-making so that all the nuances and the expertise that is gained through the well-established Administrative Procedures Act process would be utilized.

Dual trading permeates financial markets. It adds market liquidity. It occurs on every U.S. futures market, virtually worldwide in other futures markets, on securities exchanges for certain classes of members and in the "over-the-counter" stock market (NASDAQ), it is widespread in all major securities brokerage firms, and in the interbank community. Only in the futures industry, however, is the mere name itself confused with the illegal abuse: trading ahead of your customer or front-running. The point is to end abuses. That should be this Committee's goal.

As you know, the CME established a Special Committee to Review Trading Practices to offer a comprehensive review of its markets in light of the Federal investigation earlier this year.

We acknowledged both the value that dual trading provides in liquidity, and the potential harm from abuse. The CME dual trading proposal adopted a solution that would sufficiently guard against those who would abuse dual trading, while retaining the positive contribution of dual trading to liquidity. Accordingly, the Committee on Dual Trading recommended the adoption of the following proposal subject to its acceptance by the CME Board of Governors, Congress and the CFTC.

Dual trading would be allowed in any contract month in which the CFTC determines that the CTR system produces an audit trail of transactions that is accurate to the nearest minute at a 90% rate. That level of required accuracy will be increased to 92% after a very short testing period. If a contract month fails to meet that standard, then dual trading shall be prohibited with exceptions as proposed by the Special Committee, to wit:

- (1) brokers who have been given specific written

authorization from every public customer for whom the broker fills orders; (2) brokers who are filling orders for other members of the Exchange; and (3) brokers who predominantly fill spread orders.

CME Compliance Department staff supported adoption of this proposal in light of the significant improvements to CTR and to the self-regulatory capabilities of the Exchange that will be implemented as a consequence of this reform process. CME regulatory staff was satisfied that it could adequately enforce all rules respecting dual trading violations in any contract month where the 90%-92% accuracy level is met. Our staff also felt that the reference to the CFTC to authenticate compliance with the 90%-92% level assured the efficacy of the program.

It is important to note that on July 11, 1989, the dual trading proposal of the CME's internal committee was presented for review to the Special Committee to Review Trading Practices. The Special Committee accepted the internal committee's recommendations as a fully adequate response to the pros and cons of dual trading. In its deliberations, the Special-Committee took note that the balance between the contribution of dual trading to liquidity and the perceived dangers to customers is extremely delicate. Accordingly, the Special Committee unanimously agreed that the CME's internal committee's proposal is fully equivalent to its own original recommendation against this practice.

ORAL ORDERS

The CME fully understands the abuses that may be associated with unregulated oral orders. We have adopted and submitted for CFTC approval rules we believe are sufficient to deter and/or detect such abuses while preserving the benefit of oral orders for market makers who are spreading or hedging between trading pits. The liquidity provided by such market makers is highly beneficial.

The problem with the Bill is that it transfers rule-making responsibility from the exchanges to the Commission. The Commission has no reason to give high priority to the creation of such a rule. Nor is the Commission in a position to craft a single rule appropriate to the environment of each exchange. Moreover, the requirement that the Commission certify to Congress that the rule it enacts is "designed to ensure that such orders are not used to facilitate violations of that Act" is both a guarantee of no or slow action and a glaring insult to the Commission. Does Congress imagine that the Commission would design a defective rule unless it is required to certify its action?

An appropriate way to deal with the issue is to bar oral orders unless the exchanges have submitted and the CFTC has approved rules regulating such transactions. This approach will afford the same protection sought by the Bill, but is far more efficient and certainly more direct in keeping with the traditional allocation of responsibilities.

BROKER ASSOCIATIONS

The CME recognized that broker associations perform a valuable role in our markets, but can be a mechanism to facilitate trade practice abuses. The CME instituted a system of broker association registration over five years ago and implemented trading restrictions among broker association members more than two years ago.

The CME's Special Committee to Review Trading Practices recommended, and our internal Committee on Broker Associations approved, a similar set of Exchange restrictions on broker associations. Trading for a personal or proprietary account against a customer order will be prohibited among association members. Customer-to-customer order trading restrictions will be maintained at 25% of an association member's total volume in that contract.

The consequences of the restriction will be most severely felt by the customer and FCM community and the response should come from those quarters. However, customers are not so well organized as to respond in the short period available from the publication of the Bill. Following are some of the clearer problems presented.

The Bill takes a very broad and dangerous approach to a subtle and difficult problem. The Bill absolutely bars trading between members of broker associations and couples that absolute bar with an unrestrainedly, broad definition of broker associations. This is a major disservice to the users of futures markets. The Bill's rescision of the absolute bar on trading in the event that the Commission "certifies to Congress" that it has adopted rules to prevent violations attributable to trading between "affiliated" brokers is illusory. Neither rules, nor procedures or standards can guarantee that there will never be a violation of those rules.

It is unfair to expect that a federal agency will go so far out on a limb as to certify to Congress that the rules will prevent violations especially when the violations have not even been defined. Certainly, no respectable federal agency will make such a certification without years of study and assessment.

The obvious consequence will be that trading will be severely and adversely impacted in the meantime. Two

brokers employed by Merrill Lynch will not be able to trade with each other even if this means that their customers will get inferior prices. Two brokers who are limited partners in a real estate deal will be barred from trading with each other even if their customers are injured by being unable to get the best available price.

The Bill's disclosure requirement is overly broad. It requires disclosure to the Exchange and the Commission of "any affiliation." Without refinement, this language would result in de minimis affiliations being disclosed (e.g., sharing Bears tickets) and would lead to unnecessary invasions of privacy. Revisions are necessary, and delineations of required disclosures are particularly important because of the extraordinary penalties provided elsewhere in the Bill for providing any false information to an exchange. It hardly makes sense for individuals to be considered felons facing \$100,000 fines or five years in prison for failing to disclose their sharing of Bears tickets. This sounds absurd, but that would be the result of the legislation as drafted.

PENALTIES

Title VI--PENALTIES--raises severe and disturbing problems that are best addressed by the FCM community. Nonetheless, we feel compelled to briefly comment. The Bill shifts the primary responsibility for a floor broker's offenses from that floor broker to the firm that sent the order to the floor to be executed. The assumption behind this shift is that the firm should be monitoring the activities of its floor brokers and must be absolutely liable if the floor broker violates a rule.

This view of the relationship between firms and floor brokers is contrary to industry practice and is unrealistic in terms of the physical structure of a futures exchange. The firms have no way to directly observe the activities of their floor brokers. Yet the Bill makes the firms absolutely liable for single damages caused by those brokers and does not even afford the firms a right of contribution or indemnity against the broker who, by definition, was the wrong-doer.

Moreover, the firm is responsible for treble damages if it failed to monitor "the execution of the customer order at issue in such action." It is physically impossible for the firm to monitor the actual execution of each customer order. There is neither room in the pits nor could a firm find the hundreds of qualified monitors to ring the pits and observe each execution by each of the many hundreds of floor brokers used by an average firm.

OTHER ISSUES

Mr. Chairman, we have strong reservations about scores of other provisions in this Bill. We would value the opportunity to work with you, your colleagues and the Committee staff toward responsible improvements.

GLOBEX

Finally Mr. Chairman, allow me return to GLOBEX. It is perhaps unnecessary to underscore the importance we place on this idea or explain its value to the U.S. financial services arena. But for the record, we feel compelled to do so in order to draw your attention to grave dangers that perhaps are insufficiently recognized.

The world, as you know, is increasingly becoming a smaller place. What were once dozens of scattered, national economies are inexorably becoming linked into one inter-related, inter-dependent global economy. The world's financial markets are quickly following pace. In many instances, they are, in fact, setting the pace, demonstrating the ease with which capital can follow the sun, seeking out investment or risk management opportunities regardless of geographical boundaries or time zones.

The change that has washed over the world is the telecommunications revolution. It is, by now, a cliché to explain that sophisticated satellites, micro-chips and fiber optics changed the world from a confederation of autonomous financial markets into one continuous global marketplace. We need no reminder that there is no longer a distinct division of the three major time zones -- Europe, North America and the Far East. No longer are there three separate markets operating independently of external pressures, maintaining their own unique market centers, product lines, trading hours and clientele.

GLOBEX recognizes and embodies that change. It acknowledges the effects of the information revolution and responds to its reality. It consummates a marriage of current technological capabilities with established market structures. It provides the international business community with the means to respond effectively and quickly to the hazards and opportunities of continuous financial changes. It both reflects and facilitates the new globalization of capital and markets.

Just as the U.S. was the benefactor by virtue of our launch of financial futures and options two decades ago, so too will our nation derive enormous benefits if it

successfully responds to the competitive opportunities and dangers resulting from globalization. GLOBEX can insure this result.

Mr. Chairman, in the area of financial services, this nation still has the competitive edge on the world scene. We still maintain pre-eminence in the world capital markets. It is, however, clear to us that the actions by this Committee and our government could either cause us to preserve or lose that edge.

For the record, allow me to recite the best proof possible that financial futures and options are vital to the overall economy and represent indispensable risk management tools in today's business environment. Since their introduction in 1972 at the CME's International Monetary Market (IMM), financial futures experienced a transaction explosion that rivals any new product on the business scene. U.S. volume on these instruments of finance, inclusive of their option market counterparts, reached a total of approximately 171 million contracts in 1988, compared with only 445,000 in 1973, a growth factor of 38,000% for the last fifteen years.

Today, trading can be done in London or Tokyo as easily as in Chicago or New York. During the last decade, new financial futures exchanges have opened or been announced in London, Paris, Hong Kong, Sydney, Toronto, Singapore, New Zealand, Brazil, Zurich, Dublin, Frankfurt, Osaka, and Tokyo. Clearly, where once it was sufficient to have a large bank and a stock exchange in order to establish a financial center, today a financial futures exchange is needed as well. Every financial center knows the value of integrating the actual or possible movement of London's FTSE 100 and Tokyo's NIKKEI indices as harbingers of the day's S&P 500 movement.

Regulation of securities and futures markets internationally has shown little consistency across national boundaries. While regulation should be adequate, great care must be taken that our regulations do not place unnecessary constraints on the U.S. securities and futures industries. Many instruments are traded at several different locations around the world, and regulatory inequities could chase U.S. business to foreign markets.

In this respect, it is of paramount importance that our ability to promote GLOBEX around the world not be unfairly impeded by foreign governments. There is no substantial reason or rationale for any foreign government to prevent the entry or use of GLOBEX terminals within its boundaries. Without beleaguering this Committee, Exhibit B is comprised of several articles that clarify the problems we are encountering in this respect.

We are pleased to report that the United Kingdom recently provided us full permission to place GLOBEX terminals in that nation, and this was done despite the competitive pressures from various London exchanges. We also have indications that the government of France and Switzerland will act favorably on behalf of GLOBEX.

However, as these articles illustrate, there is a real danger that not all nations are willing to maintain a level playing field in this arena. There is much at stake. Our request for approval from the Ministry of Finance of Japan has, thus far, been unanswered. Our patience goes unrewarded. Indeed, we have heard the disquieting rumors that the Ministry is taking a very different approach. Accordingly, we wish to alert you to this serious danger. We have spoken with Secretary of Commerce Mosbacher, Special Trade Representative Carla Hills and other administration officials as well as Congressional leaders in this country. We will continue to do so. But this Committee in particular must be vigilant in this respect and do everything in its power to preclude any foreign nation from arbitrarily preventing this U.S. private sector initiative and ingenuity from achieving its fair competitive potential.

CONCLUSION

The Chicago Mercantile Exchange is firmly committed to meeting its self-regulatory responsibilities. We believe that our record of achievements in this area is well documented. In addition, we believe that the process by which we are examining the entire scope of our trading rules in a very thorough and thoughtful manner meets the highest goals of self-regulation.

We recognize that our customers have interests in market integrity, efficiency and liquidity. We take our obligations to safeguard these interests very seriously. Through the examination of our rule enforcement system we have sought to structure recommendations to further market integrity with a minimum of market disruption. We believe that only by allowing U.S. futures exchanges to determine market-efficient measures to meet their self-regulatory responsibilities, with CFTC oversight, will the U.S. futures industry continue to enjoy its pre-eminent role among all futures markets worldwide.

We will be pleased to answer any questions.



EXHIBIT A

CHICAGO MERCANTILE EXCHANGE

August 3, 1989

TO: ALL MEMBERS

FROM: BOARD OF GOVERNORS

RE: SUMMARY OF TRADING RULE ENHANCEMENTS
ADOPTED BY THE BOARD OF GOVERNORS

The Board of Governors, at its regular meeting on Wednesday, August 2, adopted a comprehensive set of trading rule and surveillance enhancements.

The enhancements are the result of the careful and lengthy process begun in January by the Special Committee to Review Trading Practices. The Special Committee recommendations, issued in April, were reviewed and refined by six internal committees of the Exchange, to wit:

TRADING PRACTICES/DUAL TRADING (Chairman-Steven E. Wollack, Vice Chairman-Phillip T. Karafotas); TRADING PRACTICES/BROKER ASSOCIATIONS & VERBAL ORDERS (Chairman-Louis G. Schwartz, Vice Chairman-Howard B. Dubnow); TRADING SURVEILLANCE (Chairman-Larry B. Leonard, Vice Chairman-William C. Muno); DISCIPLINARY PRACTICES (Chairman-Laurence M. Rosenberg, Vice Chairman-M. Scott Gordon); CTR ENHANCEMENTS (Chairman-Philip L. Glass, Vice Chairman-Girard G. Miller); ADMISSION REQUIREMENTS (Chairman-James E. Oliff, Vice Chairman-Michael P. Savoca).

The internal committees reports, which substantially upheld the Special Committee's recommendations, were recently submitted to the Board of Governors.

Attached is a summary of the final trading rule and surveillance enhancements adopted by the Board, to take effect upon approval by the Commodity Futures Trading Commission. It should be noted that the rule with respect to Dual Trading will be set for referendum in the near future.

On Behalf of
the Board of Governors

LEC MELAMED
Chairman, Executive Committee

JOHN T. GELDERMANN
Chairman of the Board

30 South Wacker Drive Chicago, Illinois 60606 312/930-1000
NEW YORK WASHINGTON, DC

LONDON

TOKYO



SUMMARY OF TRADING RULE ENHANCEMENTS
ADOPTED BY THE BOARD OF GOVERNORS OF THE
CHICAGO MERCANTILE EXCHANGE

THURSDAY, AUGUST 3, 1989

SUMMARY OF TRADING RULE ENHANCEMENTS
ADOPTED BY THE CHICAGO MERCANTILE EXCHANGE
BOARD OF GOVERNORS

I. TRADING PRACTICES.

A. DUAL TRADING.

1. Ban dual trading in all futures and options contract months in which the verifiability of trade times fails to meet a minimum 90% standard of accuracy. Within two years of the effective date, this requirement will be raised to a 92% standard of accuracy.
2. Require members, who on any given day have executed customer orders, to manually record the time of all subsequent personal trades to the nearest minute.
3. In the event dual trading is prohibited in a given contract month, grant the following exemptions:
 - a. To brokers who have received specific permission in writing from the ultimate customer, which specifically identifies the broker;
 - b. To brokers who predominantly conduct spread business;
 - c. To traders who fill orders for other members; and
 - d. For the purposes of correcting errors and liquidating existing positions.

NOTE: THE ABOVE DUAL TRADING RULE IS SUBJECT TO APPROVAL BY A MEMBERSHIP REFERENDUM.

B. BROKER ASSOCIATIONS.

1. Ban members of profit-sharing Broker Associations from trading for their personal account with other members in the same association executing customer orders.
2. Lower the percentage limitation from 15% to 10% on members trading for personal accounts with members of the same affiliate broker association executing customer orders.
3. Associations with any common member will be considered as one association for the purpose of the application of trading restrictions.

C. VERBAL ORDERS.

Require a member placing a verbal order to simultaneously make a written record of the order and to record the time it is placed to the nearest minute. Strictly enforce compliance with existing recordkeeping rules for verbal orders.

NOTE: The foregoing requirement does not apply to orders for options versus futures and other spread strategies.

II. TRADING SURVEILLANCE.

A. REPORTING OF MATCHED TRADES FOR REVIEW ON FLOOR.

Provide all trade data, including related Computerized Trade Reconstruction times, Customer Type Indicator codes and Stop Order indicator information, for review by members on the trading floor on a next-day basis.

B. FLOOR AND OTHER SURVEILLANCE STAFF.

1. Increase the number of full-time floor surveillance staff to ensure coverage of all trading areas, including maximum coverage of market openings and closes.
2. Expand the authority of the floor surveillance staff to include immediate inspection of all trading floor documents, including customer orders and trading cards.
3. Authorize the hiring of additional Compliance staff.

C. ELECTRONIC SURVEILLANCE.

Institute electronic surveillance for investigative purposes, subject to a six-month testing period.

D. OUT-TRADE SURVEILLANCE.

Enhance the monitoring of out-trades and their resolution.

III. DISCIPLINARY PRACTICES.

A. COMMITTEE COMPOSITION.

1. Appoint non-members to all major disciplinary committees.
2. Prohibit members, who have been found guilty of major rule violations within the last five years, or substantive minor rule violations within the last three years, from serving on the Exchange's membership, disciplinary and floor education committees.

B. PENALTY STRUCTURE.

In addition to existing penalties, adopt special penalty guidelines for rule violations involving financial injuries to public customers.

1. Major rule violations.
 - a. First offense -- Six months suspension of all membership privileges; and
 - b. Second offense -- Expulsion.
2. Minor rule violations.
 - a. First offense -- Thirty days suspension of all membership privileges;
 - b. Second offense -- Six months suspension of all membership privileges;
 - c. Third offense -- One year suspension of all membership privileges; and
 - d. Fourth offense -- Expulsion.
3. Deviations from guidelines must be explained in the official record of the proceeding.

C. APPEALS OF PROBABLE CAUSE COMMITTEE DECISIONS.

Allow Compliance staff to appeal decisions of the Probable Cause Committee.

IV. COMPUTERIZED TRADE RECONSTRUCTION (CTR) ENHANCEMENTS.

- A. Require separate time brackets for market openings and closes.
- B. Require hourly pick-up of trading cards.
- C. Reduce the present 30-minute brackets to 15-minute brackets.
- D. Require floor brokers and traders to designate spread trades.
- E. Require submission of order type indicator with other clearing information.
- F. Require that clocks be changed to reflect military time to accommodate GLOBEX and the receipt of orders during non-trading hours.
- G. Study feasibility of synchronizing trading floor clocks.

V. ADMISSION REQUIREMENTS.A. FLOOR EDUCATION PROGRAMS, INCLUDING PROGRAMS ON ETHICS.

Create a separate Ethics and Education Department, with a director who reports to the President.

B. APPLICATION PROCEDURES.

Require a member-applicant to apply for a floor broker's license with the National Futures Association, thereby requiring a more thorough background check, including a fingerprint check with the FBI.

Business

EXHIBIT B

Chicago Tribune Thursday, September 28, 1989

Merc's Globex faces Japan cold shoulder

Pressure to shun system reported

By Ronald E. Yates
Chicago Tribune

TOKYO—In what could be a major blow to the Chicago Mercantile Exchange, sources in Tokyo's financial community confirmed Wednesday that the Japanese government is pressuring Japanese members of the Merc not to participate in the exchange's new automated global futures trading network.

The pressure, the sources say, is coming from the powerful Ministry of Finance—the agency that exercises tight control over Japan's financial markets and stock exchanges.

"It's another example of the mighty hammer of Japanese bureaucracy crashing down on the concept of free trade," said a U.S. trade official in Tokyo.

Specifically, the ministry has asked several major Japanese financial institutions, including Mitsui Trust and Banking Co., not to participate in the Merc's Globex futures trading system—an innovative, 24-hour electronic trading system. The Merc and other exchanges that join Globex will list key contracts that will trade electronically during the exchanges' nighttime hours.

So far, the New York Mercantile Exchange, the Sydney Futures Exchange and the Paris-based MATIF exchange have joined Globex, which is to begin operation by year's end.

"It will be a shame if Tokyo is left out of the Globex network," said an executive with Daiwa Securities, the Japanese giant. "It will be a shame not only for Tokyo, but for Globex, which will be a bit like a three-legged horse."

Members of exchanges that join Globex will have the right to an electronic trading terminal. The assumption has been that many terminals will be placed in key foreign money centers, such as London or Tokyo, to operate during the daytime there.

A source within Japan's Fi-

nance Ministry said one reason for the pressure is concern over the competition Globex will create for Japan's own futures markets, such as the fledgling Tokyo International Financial Futures Exchange (TIFFE), which opened in June.

The Finance Ministry has been studying the Globex proposal for more than a year and has been dealing with the Merc's top executives since 1987, when the Merc opened its Tokyo office—the first non-Japanese exchange to be represented in Japan.

After repeated briefings and explanations of Globex by Leo Melamed, Merc executive committee chairman, and other Merc executives, the ministry, in a style typical of Japan's plodding bureaucracies, refused to commit itself one way or the other and recommended "further study."

Kazuo Oda, of Mitsui Trust & Banking's planning division, confirmed that Mitsui had withdrawn its application to participate in Globex, saying only that the bank had decided to "take a little more time to study the system."

The ministry's apparent decision to steer Japanese financial institutions away from Globex is an indication that it has made its decision on the Merc's new idea—at least for the time being.

But as often happens within the vapory confines of Japan's powerful bureaucracies, the ministry has not told the Merc of its decision, nor has it issued any formal public verdict on Globex.

The Merc, meanwhile, has taken a long-term view of the situation and insists on maintaining a stiff upper lip.

"As far as we are concerned, the Japanese are still studying the matter," said Nick Ronalds, deputy managing director of the Merc's Tokyo office. "We've provided them with all the information, and we are still waiting for their response. At this point, we have no

indication that they won't eventually approve Globex."

In Chicago, Merc executives had no comment, saying they had "no direct knowledge" of Japanese efforts to stifle Globex.

However, the moves in Japan could hardly come as a surprise. Executives of the Merc and of the Chicago Board of Trade, which also is developing an after-hours computerized trading system, have said all along that the technology raises tricky regulatory questions. The key issue is who has the right to regulate Globex—the U.S., where the system is based, or the foreign countries in which Globex terminals are placed?

Merc and Board of Trade officials are discussing the possibility of combining their computerized trading systems.

Within the Japanese financial community, there is concern that the Finance Ministry's move to protect the Tokyo futures market from the Globex plan could create a severe backlash as far as Japanese financial institutions are concerned.

Not only could the fate of Globex be brought up during sensitive Structural Impediments Initiative talks, which began in Tokyo early this month and will continue in Washington in October, but Japanese financial firms could face some form of retaliation from an angry U.S. Congress.

The Japanese government's reluctance to approve the Globex system stems partly from a deep-seated fear that because of its electronic, 24-hour nature, it will be difficult for the Finance Ministry to regulate.

"The idea of control is very important to Japan's Finance Ministry, and the prospect of losing that control is terrifying to its bureaucrats," said economist Tetsuo Takeuchi.

But the primary reason for the ministry's snail-paced examination of Globex is the fear expressed by officials of the Tokyo International Financial Futures Exchange that as



soon as Globex goes on line, Japanese traders will forsake TIFFE for the Merc to trade Eurodollar futures—the most popular of three financial instruments currently listed on the Tokyo futures exchange.

For the last three years, Japanese financial firms have used the Merc and the Board of Trade as classrooms to learn the intricacies of futures trading. They have quietly purchased memberships on both

exchanges so they can represent their Japanese institutional clients in Chicago's trading pits.

"It's the repetition of a typical Japanese strategy," said an American analyst with a Japanese securities firm. "You go in, learn all you can, take it back to Tokyo and keep the lid on foreign competition in your own market until you are up to speed. Then you leave both the Merc and Chicago Board of Trade in the dust. Globex is a new wrinkle, and the Japanese are afraid of it."

Sallie Gaines contributed to this report from Chicago.

Wall Street Journal Sep 26, 1989 P. C21

Chicago Merc Futures Venture Slowed by Japan

By SCOTT McMURRAY
And MASAYOSHI KANABAYASHI
Staff Reporters of THE WALL STREET JOURNAL

Japanese officials may be dragging their feet in approving Globex, an electronic futures market being developed jointly by the Chicago Mercantile Exchange and Reuters Holdings PLC, following a slow start for a recently launched futures market in Japan.

The issue of a slowdown in the approval process was raised in recent days when Mitsui Trust & Banking Co. withdrew its Globex application, futures industry officials in Tokyo and Chicago said. Officials at Mitsui, one of the largest trust banks in Tokyo, were unavailable to comment on their withdrawal. A Chicago Merc spokesman said that the Globex application roster was confidential.

But officials at Merc member firms, who asked not to be named so as not to risk losing business with Japanese institutional customers, speculated that the delay was deliberate. Even though they are confident that Japan eventually will approve Globex, they said the Japanese government, in appearing to shield a domestic exchange from foreign competition, is being consistent with its protective stance

taken toward other Japanese industries.

Globex was designed in part to tap the growing demand in Asian and European markets for trading financial futures contracts outside of Chicago trading hours. With its huge pools of investment capital, Japan is considered crucial to the long-term success of the planned computerized trading system, which initially will allow traders to buy or sell certain Merc financial futures contracts when the exchange is closed.

A substantial delay in Japan's approval of Globex would be a blow to the planned system, and could weaken its chance to gain a clear competitive advantage in Asian markets over potential rivals, Merc members said. The Merc's image as the leading innovator among U.S. exchanges could also be tarnished if Globex's expansion is hamstrung for months by Japanese officials.

Globex is expected to begin trading on a limited basis in Chicago, New York and London by year end or early in 1990, Merc officials say. Other futures exchanges in the U.S. and abroad are likely to join Globex in coming months and eventually list certain of their contracts on the system. The Merc is also negotiating with the Chicago Board of Trade to merge Globex with a similar electronic trading system being developed by that exchange.

An official from Japan's Ministry of Finance denied that the government pressured Mitsui or others to back away from Globex following the lackluster launch in June of the Tokyo International Financial Futures Exchange, a bank-owned futures market. Except for trading in a Euroyen

interest rate futures contract, the fledgling Tokyo exchange has been a disappointment, Japanese futures traders say.

"We have never said no" to institutions wanting to join Globex, the Finance Ministry official said. "We've just said wait until the system [Globex] becomes clear," he said. Japanese regulators are studying Globex, but the official wouldn't say when the study is expected to be completed.

One apparent sticking point in the minds of Japanese officials is who would have authority to investigate trades if trouble develops. "Who will take responsibility?" the official asked. "The problem isn't solved."

The Merc spokesman said the exchange was cooperating with the Finance Ministry's review of Globex. "We have no reason to think things aren't going well," he said.

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Finance Ministry halts moves by Japan firms to join Globex

By Fumio Okamoto

JAPAN ECONOMIC JOURNAL STAFF WRITER

Japan's Finance Ministry is applying the brakes to cash-rich Japanese financial juggernauts that want to participate in a new state-of-the-art global trading system.

The automated system, called Globex, is the brainchild of the Chicago Mercantile Exchange and was expected to begin operation in futures and options contracts before year's end in New York, Chicago and London.

However, according to reliable sources, the ministry is apparently worried about possible fierce competition with the fledgling Tokyo futures market.

The sources said the ministry recently persuaded Mitsui Trust & Banking Co. to withdraw its application to install Globex terminals.

Further, the ministry's small-paced examination of Globex means it is unlikely that any traders in Japan will be able to use the system when it starts operating, the sources added.

U.S.-Japan friction?

According to Japanese bank and brokerage house officials, the Ministry of Finance's apparent antipathy toward Globex could stir financial friction between the U.S. and Japan.

That's in part because the Chicago Mercantile Exchange, or Merc, is known for its clout on Capitol Hill. The exchange ranked 14th in political contributions from organizations in 1988, according to a survey by Common Cause, a Washington-based public interest lobby.

At a time of already sensitive Japan-U.S. trade relations, bankers fear Washington will use the issue as another

market-opening ploy.

Ministry officials deny that they oppose Globex. But they acknowledge concern over the system's introduction.

"We have to seriously consider what influence Globex will exert on the domestic market," said Motoo Kasakabe, chief of the ministry's capital markets supervisory team.

Takeshi Hashimoto, assistant general manager of Mitsui Trust's international treasury



While the Chicago Mercantile Exchange will soon be linked to international traders, installation of terminals in Japan is still in question.

division, declined comment on the bank's decision to withdraw its application.

According to Japanese bankers, the Globex issue apparently reflects financial regulators' anxiety that the automated system might ruffle feathers at the Tokyo International Financial Futures Exchange, which opened in June.

Trading in Eurodollar futures, one of three vehicles listed on the Tokyo exchange, is dwindling in the face of competition by the Singapore International Monetary Exchange.

The Singapore exchange recently announced that it will launch Euroyen interest rate futures contracts, the centerpiece of the Tokyo exchange, Oct. 27.

If the Finance Ministry approves Globex, some traders said they would be tempted to trade Eurodollar futures through the Merc system rather than on the Tokyo exchange because of Chicago's greater liquidity.

Given further delays, the Merc will not approve requests from Japanese firms to acquire clearing-house status —Takemura

Not shut out

Japanese and U.S. officials note that Japanese businesses are not completely shut out of the new Globex system.

According to Nicholas Ronald, deputy managing director of the Merc's Tokyo office, Globex is open to Merc clearing houses and their parent companies, both domestic and foreign.

Three Japanese companies — the U.S. subsidiaries of Daiwa, Nikko and Yamaichi securities companies — already have clearing house status, meaning

Government stymies bids to join Globex

(Continued from Page 1)

they can trade on their own accounts and for others.

However, to install and use Globex terminals in Tokyo, these firms' parents would need the Finance Ministry's approval.

And the Merc has developed a program that allows up to 50 Merc ordinary members to trade on their own accounts through Globex.

At least one Japanese company, BOT Futures Co., a New York-based subsidiary of Bank of Tokyo, is now applying for ordinary Merc membership in a bid to install Globex terminals.

While all these Japanese companies appear eligible to trade using Globex outside Japan, it is still unclear when and whether the Finance Ministry will allow Japanese financial institutions to install terminals, even at their U.S. units, the Merc's Ronalds said.

"We haven't reached any definite in-house conclusion over the matter," said Hideki Nemoto, a Finance Ministry banking supervisor in charge of capital markets.

He said the ministry's three bureaus involved in Globex — banking, securities and international finance — have just begun to study the new type of trading.

Nemoto said that before the ministry approves Globex, it must clear a number of hurdles — from risk management measures to jurisdiction over the "borderless" transactions — with the U.S. Commodities Futures Trading Commission.

Under such circumstances, many Japanese banks and bro-

1st global commodity market

Globex is the world's first major effort, conceived by the Chicago Mercantile Exchange and Reuters Holdings Plc., in London, to establish a global, electronic commodity market, by allowing traders to execute orders on screens around the world.

Eventually, Globex is intended to operate worldwide, listing futures and options contracts, such as Eurodollars, precious metals, oils and currencies, from far-flung exchanges. The contracts would

be traded on Globex during the 16 hours when the Chicago exchange is closed.

After winning unanimous approval from the U.S. Commodity Futures Trading Commission in February, the Merc has been conducting global marketing activities to link the Chicago bourse with the world's key players.

To date, the Sydney Futures Exchange, the New York Mercantile Exchange and the MATIF of France have agreed to join the system.

keage houses interviewed said they must keep a close watch on ministry moves before making a decision. Most added that they are very interested in introducing Globex.

Although the Merc's Tokyo office this year has delivered a number of lectures on Globex to ministry officials, the ministry has yet to explain why the proposed system should not go forward, according to Ronalds. Initially, the Merc planned to start Globex trading in Tokyo in October.

For the Merc, participation of Japanese financial institutions are a key to completing its global strategy, geared to combatting its rival, the Chicago Board of Trade.

The Finance Ministry apparently faces the dilemma of

claiming to postpone making a final decision "for the sake of protecting the domestic market" or of approving the Merc's request to introduce terminals that might sap the Tokyo market.

If the ministry continues to postpone action, the Merc will likely pressure Congress to take retaliatory measures against Japanese financial institutions, according to industry sources.

Even the ministry's Kusakabe acknowledged the possibility of such a scenario.

"Given further delays (by the ministry), the chances are that the Merc will not approve any requests from Japanese firms to acquire clearing-house status," said Hideo Takemura, deputy general manager of Yamaichi Securities Co.'s foreign bond department.

Senator HARKIN. Thank you, Mr. Melamed.
Mr. Guttman.

**STATEMENT OF Z. LOU GUTTMAN, CHAIRMAN OF THE BOARD OF
DIRECTORS, NEW YORK MERCANTILE EXCHANGE, NEW YORK,
NY**

Mr. GUTTMAN. Good afternoon Mr. Chairman and members of the committee. Thank you for providing the New York Mercantile Exchange with this second opportunity to appear before the committee to discuss the reauthorization of the CFTC and to share our views on S. 1729.

**NYMEX STRONGLY SUPPORTS THE COMMITTEE'S EFFORTS TO
STRENGTHEN THE OVERSIGHT OF THE FUTURES AND OPTIONS INDUSTRY**

My comments today will be brief. NYMEX strongly supports the committee's efforts to strengthen the oversight of the futures and options industry. It has been said very often over the past several months that there's a crisis of confidence in the integrity of our markets. Your constituents undoubtedly want to know what you have done to protect them. You in turn want and have the right to know what we as exchanges and the CFTC are doing to regulate our markets. The bottom line is we all have to work together to maintain the public confidence and to take the necessary steps to ensure that our markets are not susceptible to fraud or abuse.

I would like to submit my written statement for the record as well as the joint statement submitted by the four New York exchanges.

COMPETITION

There is only one subject that I wish to address today, Mr. Chairman and members of the committee, along the same lines as my colleagues from Chicago, and that is competition—specifically, the competition facing the U.S. futures and options exchanges from abroad and at times at home.

**OUR COMPETITION COMES FROM A VARIETY OF SOURCES, NONE OF THEM
AS HIGHLY REGULATED AS THE U.S. FUTURES INDUSTRY**

Our competition comes from a variety of sources, none of them as highly regulated as the U.S. futures industry. Over the past few years, energy futures markets in direct competition with NYMEX, have opened in London, Singapore and, most recently, in Rotterdam. An exchange in Tokyo competes directly with NYMEX's platinum contract and, we understand, the Japanese will shortly begin to trade energy futures.

Futures markets, or risk-shifting markets, compete with each other on three basic points—market integrity, market efficiency, and price.

MARKET INTEGRITY

On the issue of market integrity, it is NYMEX's belief that U.S. contract markets have always provided the highest level of customer protection in the world.

MARKET EFFICIENCY

At present, U.S. contract markets are also the most efficient in the world. Open outcry auction trading has survived the test of time and consistently provided the narrowest ranges between bids and offers and the ability to execute large orders with the least amount of disruption.

THERE ARE THREE PROVISIONS OF THE BILL THAT WE BELIEVE HAVE SIGNIFICANT POTENTIAL TO DECREASE MARKET EFFICIENCY AND, THEREFORE, WEAKEN OUR COMPETITIVE POSITION

There are three provisions of the bill that we believe have significant potential to decrease market efficiency and, therefore, weaken our competitive position. The first is the requirement that, in 3 years, the exchanges employ hand-held technology to record trades and execution times of transactions on exchange floors. Let me assure you that we are working diligently at developing technology that will enable us to meet this standard, but the technology is not there yet, and while our efforts are sincere, there is no assurance that it will be there in 3 years.

Now, in listening to the opening remarks of Chairman Mahlmann from the CBT, he has said that it will be there in 3 years, and I would like to assure you that if it is, NYMEX will be there to participate.

The speed at which our markets operate is well documented. Frankly, our speed is what gives our customers the best prices and is the basic reason for our success. Computer technology that could slow the process, either because its response time is too slow or because a broker would be required to input information at a time he should be executing customer orders, clearly threatens our ability to compete with other markets.

OUR FEAR THAT THE PRESSURE OF THE 3-YEAR DEADLINE WILL LIMIT THE AMOUNT OF TESTING THAT WILL BE DONE AND LOWER THE QUALITY AND RELIABILITY OF THE FINISHED PRODUCT

The bill would require us, as prudent businessmen, to make our planning decisions today, in 1989, under the assumptions that the technology will be the mandate in 1992. In is our fear that the pressure of the 3-year deadline will limit the amount of testing that will be done and lower the quality and reliability of the finished product.

While we recognize Congress' desire to keep our feet to the fire on this issue, we would respectfully request that the 3-year deadline, even with its potential for extension, be removed from the bill. Congress and the CFTC, today, have the oversight authority to monitor our progress in developing the appropriate technology.

ANOTHER POTENTIAL FOR HARMING OUR MARKET EFFICIENCY COMES FROM THE POTENTIAL DUAL TRADING PROHIBITION

Another potential for harming our market efficiency comes from the potential dual trading prohibition. We share Congress' belief that exchanges should have systems in place to deter, detect and punish trade practice violations and that if a practice is inherently

bad or systematically unpoliceable, it should be abolished. However, NYMEX believes it has been well established that dual trading itself is not bad and that the elimination of dual trading may have very limited benefits in preventing the types of violations alleged to have occurred in Chicago.

Notwithstanding statements you have heard today, we continue to believe that dual trading plays a role in the efficiency of our markets by providing the capital and liquidity. As there are no test markets to use as a control for an empirical study, as the bill would require in order to preserve dual trading from a potential prohibition, we are concerned that it may be impossible to sustain the burden of demonstrating a "substantial likelihood" that a dual trading ban will harm the public interest. Our actively trading markets are not the place to conduct that experiment, Mr. Chairman. There are other, far less risky methods of protecting our markets' integrity.

RESPONDEAT SUPERIOR LIABILITY ON A FUTURES COMMISSION MERCHANT FOR THE ACTS OF AN INDEPENDENT FLOOR BROKER HAS THE POTENTIAL TO HARM OUR MEMBERSHIP COMPOSITION AND DEVELOPMENT

Finally, the provision of the bill that would provide *respondeat superior* liability on a futures commission merchant for the acts of an independent floor broker has the potential to harm our membership composition and development. Independent floor brokers are entrepreneurs who fill gaps in the need for brokerage services where and as they arise. In lieu of accepting employer-type liability for the acts of independents over whom they cannot exercise complete control, FCM's are likely to use exclusively employee floor brokers and the markets will lose their flexibility and efficiency that independent floor brokers provide.

WE STRONGLY OPPOSE THE SERVICE FEE PROVISION IN THE BILL

One last issue I would like to discuss is the service fee. We strongly oppose the service fee provision in the bill, which merely represents an additional tax on our industry. The tax is duplicative, inasmuch as the bill is requiring exchanges to perform the regulatory function under strict penalty of law and it is then charging them a fee to ensure the performance of that function.

Accordingly, we would request that the service fee provision be deleted from the bill. In its place, we believe a study, along the lines of Senator Boschwitz' statement earlier, that would assess the effect of service fees on our ability to compete with foreign competitors. Any step which could have a direct economic advantage to our competitors should be discouraged.

SUMMARY

To summarize quickly, we respectfully request this committee to carefully consider the cumulative impact of this bill on our competitiveness in the world marketplace. We also ask that you carefully consider the many technical and due process issues raised in the joint New York Exchange letter.

Mr. Chairman, let me assure you, with respect to those changes, that we are not attempting to weaken the bill at all. We merely want to ensure that its provisions are able to operate as intended. We hope that we can work with your staff to address these issues prior to a full committee vote.

Thank you for your time.

[The prepared statement of Mr. Guttman follows:]



New York Mercantile Exchange

Statement of Z. Lou Guttman
Chairman of the Board of Directors
New York Mercantile Exchange

Before the
United States Senate
Committee on Agriculture, Nutrition & Forestry

October 17, 1989

Good morning Mr. Chairman and Members of the Committee. Thank you for providing the New York Mercantile Exchange with this second opportunity to appear before the Committee to discuss the reauthorization of the CFTC and to share our views on S. 1729.

My comments today will be brief. NYMEX strongly supports the Committee's efforts to strengthen the oversight of the futures and options industry. We recognize that in drafting this legislation, the sponsors have endeavored to ensure that the futures and options industry in the United States is the fairest and the most honest in the world. As I told this Committee in May, we share that goal. We also believe that the sponsors have given serious attention and effort to minimizing the disruption to the present method by which business is done on our Exchanges. In most respects, they have succeeded.

NYMEX has several important recommendations for technical amendments and amendments aimed at ensuring fundamental fairness in the process of assessing and sanctioning exchanges. Our recommendations are contained in a joint letter submitted to members of the Committee by all of the New York exchanges and I will not address them today. I am confident that we can work with the Committee and its staff to resolve these concerns.

There is only one subject that I want to address today -- Competition. Specifically, the competition facing the U.S. futures and options exchanges today from abroad and at home.

I know that I do not need to educate this Committee on how improved communications and the fungibility of money have made the international financial markets far more competitive over the past few years. The ability of market participants to "pass the book" around the globe has made it possible for markets in Asian and European time zones to develop and thrive. In some cases, the same products trade around the clock. In other cases, "look-alike" products trade in the various time zones and are used for the same hedging and pricing purposes as the previously existing and better developed United States product.

Our competition comes from a variety of sources, none of them as highly regulated as the U.S. futures industry. Over the past few years, energy futures markets in direct competition with NYMEX, have opened in London, Singapore and, most recently, Rotterdam. An exchange in Tokyo competes directly with NYMEX's platinum contract and, we understand, the Japanese will shortly begin to trade energy futures. Our competition also comes from non-exchange products traded in the U.S. and overseas. Forward contract trading markets, very similar to futures markets, but without regulation, play a large role in the energy trading arena. In addition, the CFTC recently authorized non-registered swap transactions in commodities that serve many of the same risk-shifting functions as futures contracts. As soon as that happened, our competitors begin to run full page advertisements in the Wall Street Journal and elsewhere, inviting our market participants to trade these unregulated contracts. The swap market appears to be growing rapidly.

Futures markets, or risk-shifting markets, compete with each other on three basic points -- Market Integrity, Market Efficiency and Price. We hope that Members of the Committee will carefully consider the cumulative cost of this legislation in terms of market efficiency and price prior to voting on the entire package of reforms.

On the issue of Market Integrity, it is NYMEX's belief that U.S. contract markets have always provided the highest level of customer protection in the world. As I said at the outset, we support the proposed legislation insofar as we believe that it will enhance market integrity and improve our image in the public's eye. In those respects, it should strengthen our ability to compete.

At present, U.S. contract markets are also the most efficient in the world. Open outcry auction trading has survived the test of time and consistently has provided the narrowest ranges between bids and offers and the ability to execute large orders with the least disruption.

There are three provisions of the bill that we believe have significant potential to decrease market efficiency and, therefore, weaken our competitive position. The first is the requirement that, in three years, the exchanges employ hand-held technology to record trades and execution times of transactions on exchange floors. We are working diligently at developing technology that will enable us to meet this standard. Indeed, as our colleagues from COMEX have told you, the New York exchanges have been working on the project since long before this reauthorization process began, because it was perceived that technology, if it could be developed, could actually enhance market efficiency.

But the technology is not there yet. And while our efforts are sincere, there is no assurance it will be there in three years. The speed at which our markets operate is well documented. Frankly, our speed is what gives our customers the best prices and is the basic reasons for our success. Computer technology that could slow the process, either because its response time is too slow or because a broker would be required to input information at a time he should be executing customer orders, clearly threatens our ability to compete with other markets.

We acknowledge that the bill contains a provision which would permit a delay in the three-year effective date of this provision if the CFTC and GAO believe it necessary. However, as prudent businessmen, we must make our planning decisions today -- in 1989 -- under the assumption that technology will be the mandate in 1992. Accordingly, in assessing the alternatives available today, some cheaper or more efficient than others but not available on a time schedule that would permit implementation in three years, the bill would require us to choose more expensive or less efficient alternatives. In addition, by setting an implementation date, the bill essentially mandates the amount of testing that can be done with technology. As we all know, each phase of development must be completed before the next can begin. It is our fear that the pressure of the three-year deadline will limit the amount of testing that will be done and lower the quality and reliability of the finished product.

While we recognize Congress' desire to keep our feet to the fire on this issue, we would respectfully request that the three-year deadline (even with its potential for extension) be removed from the bill. Congress and the CFTC have the oversight authority to monitor our progress in developing the appropriate technology. We would submit that this deference to the efficiency of our markets would not weaken our drive or commitment to achieve the intended result.

Another potential for harming our market efficiency comes from the potential dual trading prohibition. We share Congress' belief that exchanges should have systems in place to deter, detect and punish trade practice violations and that if a practice is inherently bad or systematically unpoliceable, it should be abolished. However, NYMEX believes it has been well established that dual trading itself is not bad and that the elimination of dual trading may have very limited benefits in preventing the types of violations alleged to have occurred in Chicago.

Congress has also heard the arguments -- and I won't repeat them -- that dual trading plays at least some role in the efficiency of our markets, by providing capital and liquidity that allows market participants to price and shift risk with the narrowest bid-ask spreads in the world. The narrowest bid-ask spreads, of course, give customers the best prices.

The way the bill is currently written, if the loss of dual trading is threatened, a contract market could only save it if the contract market could demonstrate a "substantial likelihood" that the suspension would harm the public interest. We submit that such standard is too high. As there are no test markets to use as a control for empirical study, we are concerned that it may be impossible to sustain a burden of demonstrating a "substantial likelihood" that a dual trading ban will harm the public interest. Our actively trading markets are not the place to conduct that experiment. There are other, far less risky, methods of protecting our markets' integrity.

Finally, the provision of the bill that would provide respondeat superior liability on a futures commission merchant for the acts of an independent floor broker has the potential to harm our membership composition and development. Independent floor brokers are entrepreneurs who fill a valuable service to the market in being willing "free agents" filling gaps in

the need for brokerage services where and as they arise. In lieu of accepting employer-type liability for the acts of "independent" over whom they cannot exercise complete control, FCMs are likely to use exclusively employee floor brokers. This will drive the floor brokerage business into the FCMs, eliminate the efficiencies provided by the independent floor brokers and prevent the entry and growth in our membership of these small entrepreneurs.

On the issue of Price-competitiveness, many of the responses to the events of the last several months will increase our cost of doing business.

Many are self-imposed. We have committed additional resources to our Compliance Department staffing and systems development. We have increased our trade documentation requirements resulting in additional administrative and recordkeeping costs. We have committed to the development of hand-held technology and electronic trading. All of these increased costs we can accept because they will improve our ability to detect and deter rule violations.

The bill also imposes certain costs associated with its regulatory provisions. To name just a few, increased CFTC reviews of exchange trade monitoring systems will cost money. Restrictions on oral orders will impose costs to compensate for the efficiencies the practice permits. The disclosure of all broker relationships -- trading and non-trading -- will increase administrative costs.

We are ready to live with these cost increases. However, we strongly oppose the service fee provision in the bill, which merely represent an additional tax on our industry. The tax is duplicative inasmuch as the bill is requiring exchanges to perform the regulatory function, under strict penalty of law, and it is then charging them a fee to ensure that they performed that function.

Moreover, it is the exact opposite measure from those taken by your foreign counterparts who are seeking to use legislation to promote economically the development of business in the region. In Singapore, for example, where an exchange called SIMEX trades a High Sulphur Fuel Oil contract in direct competition with NYMEX, the government has capped tax rates on trading to 10% as an incentive to induce people to trade SIMEX instead of NYMEX. These foreign incentives make it difficult for us to compete. While we are not

asking for domestic incentives, quite frankly, an additional tax on us may be more than we can bear.

Accordingly, we would request that the service fee provision be deleted from the bill. In its place, we believe, a study should be mandated that would assess the effect of service fees on our ability to compete with foreign competitors. Any step which could have a direct economic advantage to our competitors should be discouraged.

* * *

To summarize quickly, we would respectfully request this Committee to carefully consider the cumulative impact of this bill on our competitiveness in the world marketplace. We would also ask that you carefully consider the many technical and due process issues raised in the joint New York exchange letter. Let me assure you with respect to those changes that we are not attempting to weaken the bill at all, we merely want to be sure that its provisions are able to operate as intended. We hope that we can work with your staff to address these issues prior to the full Committee vote.

Thank you for your time.

Senator HARKIN. Thank you, Mr. Guttman.
Mr. Fink.

**STATEMENT OF ROBERT E. FINK, CHAIRMAN, BOARD OF
GOVERNORS, COMMODITY EXCHANGE, INC., NEW YORK, NY**

Mr. FINK. Thank you, Mr. Chairman.
I am Bob Fink, chairman of COMEX.

INTRODUCTION

Mr. Chairman, there is little doubt that 1989 will be seen as a turning point for the United States futures markets. A year that began with headlines regarding undercover investigations has generated debate about reform, which at times has been marked by strident dialog among and between Congress, the CFTC, and the exchanges. Although public trust in our markets suffered a serious setback last winter, the year will end as one of great positive change. If the proposed legislation before you is enacted, 1989 will be seen as the year that led to increases in the manpower, expertise and strength of purpose of the CFTC. 1989 is also the beginning of an era in which traditional trading methods and new technologies will be intertwined in a stronger market fabric. And, finally, 1989 is a year in which this committee and its counterpart in the House of Representatives led the entire industry—exchanges and regulators alike—on a course of self-examination and broad reform.

Exactly what changes will emerge from this process remain to be seen. What is clear, however, is that the entire movement seems to be guided by one overriding principle: that the integrity of our markets is of paramount importance and that no aspect of the way we do business should be viewed as sacrosanct. COMEX believes that this should be the principle by which the process of reform is guided.

If this industry cannot demonstrate to market users and regulators that it values customer safety as its highest priority, then it should be prepared to lose, or have restricted, some of its most ingrained operating practices. At the same time, though, Mr. Chairman, care should be exercised so that reforms intended to improve the integrity of our markets do not result in the impairment of their vital economic function.

A STRONG CFTC

The primary instrument necessary to ensure that the exchanges fulfill their self-regulatory obligations is a strong and capable government regulator. This bill goes a long way toward ensuring expertise at the senior levels of the CFTC and the presence of highly qualified staff. Through its proposals for increased funding, parity pay with other Federal financial regulators, and its commitment to preserve the Commission's jurisdiction over the industry—the bill gives the agency the strength and durability that it both deserves and needs. COMEX strongly supports these provisions of the bill that are designed to add muscle to the CFTC.

S. 1729—A COMPREHENSIVE APPROACH

In addition, the bill wisely recognizes that meaningful reform cannot have as its primary means of deterrence the restriction of a particular trade practice—such as dual trading—and cannot rely upon a single instrument—such as audit trail—to detect violations. What purpose can be served by the statutory restriction of dual trading when the practice has proven assets and unclear liabilities? And what aim will be served by tightening audit trail requirements if an exchange lacks the ability or the will to make use of such information in the detection and sanctioning of misconduct? By recognizing the importance of coordinated surveillance, effective prosecution and the assessment of meaningful penalties, we believe the bill demonstrates an understanding of and a respect for the comprehensive nature of the issues.

COSTS AND EFFICIENCIES

While we support the overall approach of the bill, we would like to share with the committee some of our serious concerns, however. When taken in concert, a number of the provisions have the potential effect of raising the costs and decreasing the speed of trade executions on U.S. futures exchanges. Some of these costs are direct and obvious, such as those associated with the proposal to charge service fees to cover the cost of increased CFTC floor surveillance. Others relate to the development and implementation of the technology necessary to meet the recommended audit trail standards in 3 years. Still others—such as restrictions on dual trading—could exact their toll in the form of reduced liquidity, wider bid/ask spreads and delayed executions.

Once these inefficiencies rise above a boiling point, they have a way of causing business on the floor of an exchange to simply evaporate. We are all familiar with the arguments regarding overseas competition. For COMEX, these are not academic issues. Over the years, our exchange has lost business to foreign competitors like the London Metal Exchange due to differences in regulatory constraints. Of equal concern is the continuing loss of business from almost every U.S. exchange to the upstairs dealer markets. The result of an acceleration in the use of foreign and dealer markets could easily be that business is driven off a centrally located, well-regulated exchange floor to a far-flung and less well-regulated trading community. Therefore, we urge that restraint be used in adopting any measures that introduce added costs and inefficiencies in the trading process.

AUDIT TRAIL

On the subject of audit trails, we endorse congressional efforts to assure attainment of complete, precise and independent timing measures. However, we are very concerned about the imposition of hard and fast deadlines for compliance with these criteria.

The development of technological means by which the proposed audit trail criteria may be met is a process involving ongoing and repetitive evaluation, testing and modification. The costs and manpower associated with this process, particularly when the feasibility of the technology has not been determined, are incalculable and

of grave concern to exchanges with limited resources. Moreover, the absence of any operative model at this stage and the evolutionary nature of the development process make it impossible to gauge, with any degree of precision, the deadlines by which project completion (or any stage within the process) can reasonably be expected. Although we at COMEX will attempt to develop and implement a system that will satisfy the audit trail requirements of the bill, we urge Congress to give the CFTC substantial flexibility in defining performance measures to be met by each exchange. This would go a long way toward achieving the audit trail objectives in a way that is most cost effective and least market disruptive.

DUAL TRADING

On the subject of dual trading, COMEX has consistently taken the position that the practice makes significant contributions to our markets. Restrictions on dual trading will result in reduced liquidity and less efficient floor brokerage services.

We believe that any restriction on dual trading should result only from an action of the CFTC based on the conclusion that a particular contract market has failed to demonstrate its ability to detect and punish abusers of this practice. We do not believe that a statutory ban of dual trading is the appropriate or most effective way to ensure the absence of abusive trading practices.

COMEX'S COMMITMENTS

Mr. Chairman and members of the committee, I want to stress that our concerns and objections to some portions of the bill should not detract from our basic position that the bill can provide a sound base from which the issues can be attacked. COMEX remains committed to the task of enhancing and maintaining public confidence in our market. As demonstrated in the GAO report, our exchange has an exemplary record in detecting, prosecuting and sanctioning violators. We intend to maintain and build upon that record.

Our advanced trade submission system and preliminary work in the development of a hand-held device demonstrates our commitment to the use of the best available technology and systems.

The ongoing work of our independent Special Advisory Panel represents our intent to vigorously explore every avenue of reform.

CONCLUSION

Mr. Chairman, the legislative process will soon be coming to a conclusion. As Congress completes its deliberations on these matters, we hope that it will recognize the efforts of COMEX and those of every exchange in the country to maintain and improve the safety of their marketplace. We are concerned that the process of reform will be guided by the assumption that the industry lacks the ability or the determination to provide such safety. This industry has a renewed sensitivity to its mandates. More than ever, it is aware of the responsibilities it has to customers, to determined regulators and to a dissatisfied Congress. The industry is ready to demonstrate that it can fulfill its vital economic purpose, while en-

sureing the highest possible standards of integrity. We hope the laws that emerge from this process will allow it to do both.

Thank you.

[The prepared statement and attachments of Mr. Fink follow:]

STATEMENT OF ROBERT E. FINK, CHAIRMAN
COMMODITY EXCHANGE, INC.
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
OCTOBER 17, 1989

Mr. Chairman, members of the Committee, I am Robert E. Fink, Chairman of Commodity Exchange, Inc. ("Comex" or "the Exchange"). I am joined here today by Arnold Staloff, President of the Exchange.

Comex is the world's most active metals futures market and the fourth most active of all futures markets in the United States. Our exchange provides an arena for the trading of futures contracts on gold, silver, copper and aluminum, and options on gold, silver and copper. The users of our markets include speculators, commercial and industrial hedgers, and major financial institutions—both in the U.S. and abroad.

We appreciate the opportunity to be here today to share our views on the Futures Trading Practices Act of 1989.

Introduction

There is little doubt that 1989 will be seen as a turning point for the United States futures markets. A year that began with headlines regarding undercover investigations has generated debate about reform, which at times has been marked by strident dialogue among and between Congress, the CFTC, and the exchanges. Although public trust in our markets suffered a serious setback last winter, the year will end as one of great positive change. If the proposed legislation before you is enacted, 1989 will be seen as the year that led to increases in the manpower, expertise and strength of purpose of the CFTC. 1989 is also the beginning of an era in which traditional trading methods and new technologies will be intertwined in a stronger market fabric. And, finally, 1989 is a year in which this Committee and its counterpart in the House of Representatives led the entire industry—exchanges and regulators alike—on a course of self-examination and broad reform.

Exactly what changes will emerge from this process remain to be seen. What is clear, however, is that the entire movement seems to be guided by one overriding principle: that the integrity of our markets is of paramount importance and that no aspect of the way we do business should be viewed as sacrosanct. Comex believes that this should be the principle by which the process of reform is guided.

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If this industry cannot demonstrate to market users and regulators that it values customer safety as its highest priority, then it should be prepared to lose, or have restricted, some of its most sacred operating practices. There is every reason to believe that if we, as an industry, fail to, we will lose business to other markets in which customers believe they are treated more fairly. At the same time, care should be exercised so that reforms intended to improve the integrity of our markets do not result in the impairment of their vital economic function.

A Strong CFTC

The primary instrument necessary to ensure that the exchanges fulfill their self-regulatory obligations is a strong and capable government regulator. In addition, the increasing variety of futures contracts traded, the internationalization of our markets, and the greatly-expanded use of technology dictate the need for an expert regulatory agency that can effectively address the difficult issues facing the industry. This bill goes a long way toward ensuring expertise at the senior levels of the agency and the presence of highly qualified staff. Through its proposals for increased funding, parity pay with other federal financial regulators, and its commitment to preserve the Commission's jurisdiction over the industry—the bill gives the agency the strength and durability that it both deserves and needs. Comex strongly supports these provisions of the bill that are designed to add muscle to the CFTC.

Within the self-regulatory framework, though, the front line in the defense of public trust must be the exchanges themselves. Every exchange should be able to demonstrate its ability to live up to standards that are clearly defined and uniformly enforced by the CFTC—or face the consequences. In this regard, the bill adopts an appropriately stern, yet flexible approach. It requires exchanges to submit to periodic performance reviews by the CFTC and exposes them to potentially crippling penalties for their failure to comply with orders for remedial action.

Uniform Standards

We are also pleased to support Section 610 of the bill, which will require the Commission to conduct a penalties study and propose industry-wide guidelines or rules to make penalty levels among exchanges consistent (including, if appropriate, minimum penalties or penalty ranges for various offenses). Such penalty guidelines should help to ensure that offenders will face the same sanctions regardless of the domestic exchange on which the offense is committed. This same type of standardization may be appropriate in other aspects of the compliance and surveillance efforts of the various exchanges.

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As the GAO reported to this Committee on September 7, 1989, "[t]he number and the severity of disciplinary actions that the exchanges have taken varies considerably." (Futures Markets: Strengthening Trade Practice Oversight, (GAO/GGD-89-120) at p. 29). This disparate record of exchanges to prosecute and sanction wrongdoers has ill-served the industry. As the tabulations contained in Appendices II and III of the GAO study show, in terms of its trading volume over the past five years, Comex has assessed the highest dollar amounts of fines against its members (fine \$/trading volume) and has penalized the greatest numbers of its members (members/trading volume) (Table II.1). At the same time, our staff has had the most investigators relative to contract volume, and along with that of the CME, has had the most experienced investigators (at p. 36). While these statistics reflect our long-standing commitment to the development of a strong enforcement program, we believe that some standardization of penalties and practices could prove useful to all of the exchanges.

S.1729 - A Comprehensive Approach

In addition, the bill wisely recognizes that meaningful reform cannot have as its primary means of deterrence the restriction of a particular trade practice--such as dual trading--and cannot rely upon a single instrument--such as audit trail--to detect violations. What purpose can be served by the statutory restriction of dual trading when the practice has proven assets and unclear liabilities? And what aim will be served by tightening audit trail requirements if an exchange lacks the ability or the will to make use of such information in the detection and sanctioning of misconduct? By recognizing the importance of coordinated surveillance, effective prosecution and the assessment of meaningful penalties, we believe the bill demonstrates an understanding of and a respect for the comprehensive nature of the issues.

We have previously stated that we believe that the only effective means of combatting abuse of customer orders is to implement:

1. mechanisms to capture data that enable tracking of the flow of all orders from the time of placement, through execution;
2. means of analyzing trading data to detect patterns of unlawful activity;
3. use of the data to prosecute traders involved in unlawful activity; and
4. imposition of substantial disciplinary sanctions against those adjudged to be rule violators.

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Absent any one of these four aspects of an exchange's obligations to the investment community, customers will not be protected to the extent they should be. We are pleased to see that this is the general approach embodied in the bill.

Costs and Efficiencies

While we support the overall approach of the bill, we would like to share with the Committee some of our concerns. When taken in concert, a number of the provisions have the potential effect of raising the costs and decreasing the speed of trade executions on U.S. futures exchanges. Some of these costs are direct and obvious, such as those associated with the proposal to charge service fees to cover the cost of CFTC floor surveillance. Others relate to the development and implementation of the technology necessary to meet the recommended audit trail standards in three years. Still others—such as restrictions on dual trading—could exact their toll in the form of reduced liquidity, wider bid/ask spreads and delayed executions.

Once these inefficiencies rise above a boiling point, they have a way of causing business on the floor of an exchange to simply evaporate. We are all familiar with the arguments regarding overseas competition. For Comex, these are not academic issues. Over the years, our exchange has lost business to foreign competitors like the London Metal Exchange due to differences in regulatory constraints. Of equal concern is the continuing loss of business from almost every U.S. exchange to the upstairs dealer markets. More and more of the U.S. futures business comes from large commercial and institutional traders whose orders are extremely price-sensitive and time-sensitive. These large traders place their orders in those markets that get the job done the most quickly and the least expensively. The result of an acceleration in the use of foreign and dealer markets could easily be that business is driven off a centrally-located, well-regulated exchange floor to a far-flung and less regulated trading community.

Finally, a part of every exchange's business exists only because of low futures transaction costs and high execution speed—factors that allow dealers to act as intermediaries between the cash and futures markets. If the costs and inefficiencies of executions on the futures markets rise above some threshold, this business will vanish. The result will be a draining of liquidity from both the futures and cash markets.

The fragility that underlies these seemingly robust markets argues for restraint in any regulatory measures that introduce added costs and inefficiencies into the trading process.

Service Fees

One of our specific concerns in this regard is the service fee proposed in the bill to cover the cost of increased CFTC monitoring of exchange floor practices. Past debates over the issue of user fees resulted in the formation of the National Futures Association ("NFA"), which is wholly funded by the industry. The costs associated with funding the NFA and complying with other portions of the bill are thus factors that should be considered before action is taken with respect to service fees. Still another key consideration is the increasing globalization of the financial markets and the intense competition U.S. exchanges are facing from competing markets. Whether designated as a user fee, a service fee, or some other levy, the charge by its nature is a tax on business done on a regulated U.S. exchange. No such fee is charged for transactions in the alternative, less regulated environments, and service fees could consequently place U.S. exchange markets at a disadvantage.

For all of these reasons, we believe the advisability and ramifications of service fees should be thoroughly studied before Congress moves in this direction. Moreover, any effort to impose service fees should take into consideration not just their direct budgetary impact on the exchanges, but also their indirect effects on volume and liquidity.

Audit Trail

In a related vein, we endorse congressional efforts to assure the attainment of complete, concise and independent audit trails. We are concerned, however, about the imposition of hard and fast deadlines for compliance with these criteria.

The development of technological means by which the proposed audit trail criteria may be met is a process involving ongoing and repetitive evaluation, testing and modification. The costs and manpower associated with this process, particularly when the feasibility of the technology has not been determined, are incalculable and of grave concern to exchanges with limited resources. Moreover, the absence of any operative model at this stage and the evolutionary nature of the development process make it impossible to gauge, with any degree of precision, the deadlines by which project completion (or any stage within the process) can reasonably be expected. Although we will attempt to develop and implement a system that will satisfy the audit trail requirements of the bill, we urge Congress to give the CFTC substantial flexibility in defining performance measures to be met by each exchange. This would go a long way toward achieving the audit trail objectives in a way that is most cost effective and least market disruptive.

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Dual Trading

On the subject of dual trading, Comex has consistently taken the position that the practice makes significant contributions to our markets. Restrictions on dual trading will result in reduced liquidity and less efficient floor brokerage services.

In any trading ring, an insufficient number of well-capitalized "local" traders (those who trade solely for their own accounts) hinders a floor broker's ability to execute orders received from customers. Dual traders fill this gap and augment locals' market-maker function by enlarging the pool of traders in the ring available to take the other side of customers' bids and offers. Thus, the presence of dual traders enhances liquidity and competition in a ring.

Dual traders also supplement the brokerage capacity otherwise available only through non-dual brokers, thereby increasing the number of order-fillers available for use by customers. This measure is necessary for efficient market operations.

In addition, many customers believe that the expertise offered by dual traders as a result of their own market interests exceeds the level of performance of non-dual brokers, who are merely filling orders throughout the day.

We believe that any restriction on dual trading should result only from an action of the CFTC based on the conclusion that a particular contract market has failed to demonstrate its ability to detect and punish abusers of the practice. Given the importance of dual trading in our markets and given the likely difficulties an exchange will encounter in regaining dual trading privileges once suspended, we feel that the burden of proof should be on the CFTC to eliminate the practice rather than on the exchanges to retain the practice. We do not believe that a statutory ban of dual trading is the appropriate or most effective way to ensure the absence of abusive trading practices. We agree with the GAO, which stated in its Futures Markets: Strengthening Trade Practice Oversight Report that "...restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations." (at pp. 6 and 47).

Composition of Exchange Governing Boards

Regarding the section of the bill dealing with the composition of exchange governing boards, the Comex Board of Governors is comprised of seven representatives of futures commission merchants (Commission House Group), seven representatives of the metals trade (Trade Group), seven representatives of the trading floor (Floor Group), three non-members, and a member Chairman elected by the full membership of the Exchange. The Exchange's intent in

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establishing this form of governance was to ensure diversity of views during deliberations on all policy issues, provide for representation of all sectors of users of our markets, and obtain guidance from individuals unrelated to the Exchange and its members on matters affecting the public interest. Although we believe this intent has been realized, our present structure would not satisfy the bill's requirements. It is our view that the decision of board composition should remain in the hands of the exchanges, subject to CFTC oversight.

Broker Associations

The bill will require disclosure to an exchange and to the CFTC of all trade, business, and financial affiliations and other joint arrangements among and between floor brokers and traders. Comex requires the disclosure to the Exchange of such associations and, therefore, we have no objection to this provision.

Beginning 270 days after enactment of the bill, trading among broker association members, including customer order executions, would be barred unless the CFTC adopts rules governing such trading that it certifies to Congress will inhibit abuses. We oppose the outright ban on these practices as proposed by the bill because it may impair a floor broker's ability to obtain the best available price for his customer. We believe that no statutory restriction should be placed on trades between customers whose orders are executed by brokers within an association. Similarly, we see no need to restrict trades between brokers within an association when each is trading for his own account. We do take some comfort from the fact that the CFTC can remove the statutory bar through the issuance and certification of rules that inhibit abuses arising from broker associations. The CFTC has indicated that it will undertake rulemaking in this area. We urge the Committee to encourage the Commission to begin this process as soon as possible in order to ensure that there is a real possibility that the rulemaking can be completed before the statutory ban would be triggered.

Comex's Commitments

Mr. Chairman, I want to stress that our concerns and objections to some portions of the bill should not detract from our basic stance that the bill provides a sound and meaningful attack on the issues at hand. Comex remains committed to the task of enhancing and maintaining public confidence in our market. As demonstrated in the GAO report, our exchange has an exemplary record in detecting, prosecuting and sanctioning violators. Of the four exchanges recently studied by the GAO, in terms of trading volume, Comex placed first in the number of sanctions imposed and the total dollar amounts of fines. The report also showed that for its level of trading volume, Comex had a large and experienced compliance staff. We intend to maintain and build upon that record.

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Our advanced trade submission system and preliminary work in the development of a hand-held device demonstrates our commitment to the use of the best available technology and systems.

In this connection, Comex, on behalf of the other Commodities Exchange Center exchanges in New York (the Coffee, Sugar and Cocoa Exchange, the New York Cotton Exchange, the New York Futures Exchange, and the New York Mercantile Exchange), intends to perform in the first quarter of 1990 limited feasibility tests of a hand-held transaction entry system that is now in the very early stages of development. This system hopes to use lightweight hand-held computers designed to provide reliable and independent time recordation of at least some transactions while maintaining the current method of futures trading. With the contemplated system, individual floor traders may be able to record their transactions on the portable terminals, which would store the information on a removable diskette. If feasibility testing proves successful, the disks would be collected frequently, every 15 or 30 minutes, for entry into the Exchange's computerized trade matching and processing operation. The ultimate goal is the integration of this transaction recordation technology with our clearing system.

Comex has been researching hand-held technology for several years now. While we are hopeful about the system's potential, we must temper that hope with the possibility that the system will not operate as envisioned when tested in a "live" trading environment. It is also possible that unforeseen technologies will prove superior to those that we envision. If our method does not work, we believe the knowledge gained from this experiment and parallel development efforts by the Chicago exchanges—with which we are cooperating—will move the industry closer to the goal of combining new technology with proven and established methods of competitive trading.

The ongoing work of our independent Special Advisory Panel represents our intent to vigorously explore every avenue of reform. The Panel, comprised of representatives of our floor trading community, an Exchange public governor, representatives of the FCM and trade house communities, and a representative of the academic community with expertise in futures issues, has been working diligently to evaluate various approaches to regulatory and operational issues toward ensuring the continuation of efficient, honest, and credible markets at Comex. The panel's efforts have been very constructive. The Special Advisory Panel has assisted us in responding to the proposals aired by Chairman Leahy and various issues presented for our evaluation by the Commission. It is engaged in evaluating various approaches presented by other exchanges and the CFTC to assess which best meet our specific needs. We intend to retain this group until it has, to its satisfaction, dealt with the issues that it deems necessary and has made its recommendations.

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Conclusion

Mr. Chairman, members of the Committee, this legislative process will soon be reaching a conclusion. As Congress completes its deliberations on these matters, we hope that it will recognize the efforts of Comex and those of every exchange in the country to maintain and improve the safety of their marketplace. We are concerned that the process of reform will be guided by the assumption that the industry lacks the ability or determination to provide such safety. This industry has a renewed sensitivity to its mandates. More than ever, it is aware of the responsibilities it has to customers, to determined regulators and to a dissatisfied Congress. The industry is ready to demonstrate that it can fulfill its vital economic purpose while ensuring the highest standards of integrity. We hope that the laws that emerge from this process will allow it to do both.

SUPPLEMENTAL COMMENTS
of the
NEW YORK COMMODITIES EXCHANGE CENTER EXCHANGES
on the
FUTURES TRADING PRACTICES ACT OF 1989

This document sets forth, in a consolidated fashion, certain additional comments of the Commodities Exchange Center exchanges ("CEC Exchanges") regarding S. 1729, the Futures Trading Practices Act of 1989 (the "Senate Bill").¹ These comments attempt to identify portions of the Senate Bill that may be ambiguous or unclear, portions that may merit a somewhat different approach and portions where modifications seem to be particularly crucial. These comments are intended to supplement those contained in the oral and written presentations of each CEC Exchange and have been presented in a consolidated fashion, rather than in four separate submissions, to streamline the Senate Committee's review process. For ease of reference, the order of these comments tracks the order of the relevant provisions of the Senate Bill.

In virtually all instances, our goal was to preserve the basic intent of the Bill, but to make that intent operative in a manner that will provide clearer guidance to affected parties and be more efficient for the markets.²

I. Section 201

A. Violations "Related to" the Making of Trades

Various sections of the Bill make clear that the sponsors' focus was violations "in the making of" trades and the execution of orders on the floors of commodities exchanges. (See, e.g., page 28, line 4; page 30, line 11.) However, proposed subsection 5a(13)(A) provides that each contract market must "maintain and utilize a system to monitor trading to detect and deter violations of this Act related to the making of trades and the execution of customer orders on the floor or subject to the rules of such contract market." (Page 4, line 5; emphasis

¹ The CEC Exchanges include the Coffee, Sugar & Cocoa Exchange, Commodity Exchange Inc. ("Comex"), the New York Cotton Exchange and the New York Mercantile Exchange ("NYMEX").

² In view of the relatively brief period of time the exchanges have had to review and digest this legislation, the exchanges may subsequently wish to bring further comments or suggestions to the Committee's attention.

added.) Because virtually any commodities violation could be deemed to be "related to" the making of such trades or the execution of such orders, this provision sweeps much further than the Bill's sponsors presumably intended. We would therefore recommend that the word "in" be substituted for the words "related to," to make this provision consistent with other portions of the Bill.

B. "Independent Source" and "Continually Recorded"

Proposed subsection 5a(13)(C) specifies that, beginning three years after the date of enactment, the audit trail systems of the exchanges must record all trades accurately and promptly "by a source independent of the person making the trade and continually recorded in the record of the contract market (including through a mechanism that records the time of execution of each trade automatically when entered by such person and records essential data in a form that cannot be altered except in a manner that will leave a complete and independent record of any such alteration)" (Page 5, line 10.)

Although this provision would appear to permit the use of a hand-held device of the sort that is currently being developed by the CEC Exchanges, it contains many terms that would be new to the commodities industry. It would therefore be desirable to relate these terms to hand-held devices and any other technological advancements that are currently in the "R&D" stage.

For example, the Committee should clarify that such a device would be an "independent source," that the language requiring all trades to be "continually recorded in the record of the contract market" would permit some form of batch processing, such as the collection of data on diskettes in the hand-held units, and that a transcription of such a diskette would constitute the "record of the contract market."

The development of a hand-held device will entail significant time and expense, and the exchanges therefore need assurance that this device would satisfy their statutory obligation.

C. "To the Extent Feasible as Determined by the Commission"

In one instance, proposed subsection 5a(13)(C) provides that specified objectives must be achieved "to the extent feasible as determined by the Commission." (Page 6, line 3.) On two other occasions, this paragraph specifies that goals must be achieved "to the fullest extent feasible as determined by the Commission by rule." (Page 5, line 22; page 6, line 25; emphasis added.) It is unclear why references to rulemakings are used in two instances but not in one. If the Committee intends that the issue of feasibility be resolved by rules that will have across-the-board applicability to all exchanges, all such references should presumably include the words "by rule." If, however, the Committee believes the Commission should have the flexibility to address this matter on a per-contract-market-basis, these provisions should reference the word "order." (This same comment also applies to other portions of the bill, e.g., page 8, line 8.)

Additionally, it is unclear why subsection 5a(13)(C) (ii) contains two separate references to "the extent feasible." (Page 6, line 3; page 6, line 25.) The first use of this concept presumably modifies all portions of this subparagraph; however, the repetition of this concept (albeit in somewhat different form) generates some confusion on this point. To foreclose speculation that this dual usage has some hidden significance, the second reference to this language should presumably be deleted.

II. Section 202

A. General Procedural Concerns

The CEC Exchanges have several concerns about the procedures the Bill would create for Commission review of the exchanges' market surveillance and audit trail systems and the remedies the Commission could mandate if it believed "deficiencies" existed. Those procedures would be entirely new to this industry and those remedies could be costly and far-reaching. Accordingly, we believe those procedures must be carefully developed to ensure fundamental fairness, while promoting our mutual desire for commodities markets that enjoy the highest degree of investor confidence. In that spirit, we have suggested certain changes that would help to assure that the Commission's sweeping new powers would be utilized in a responsible fashion, but would not impair the Commission's ability to mandate necessary changes in exchange surveillance systems and procedures.

B. Status of "Interim Orders"

Proposed subsection 8e(b) would permit the Commission to enter an "interim order" if it "finds" that a contract market "has failed to demonstrate" that its trade monitoring system complies with the requisite audit trail standards and that certain other statutory standards are being met. (Page 7, line 17.)

The use of the term "interim order" in this subsection creates substantial confusion, because it suggests such an "order" might have some force and effect prior to the point at which it becomes final -- a result the Bill's sponsors presumably do not intend. This confusion is exacerbated by the fact that proposed subsection 8e(e) (page 13, line 20) states that "violation of an order" shall be considered a violation of an order of the Commission for purposes of assessing penalties and initiating proceedings to suspend or revoke an exchange's designation as a contract market. To dispel the confusion on this point, we would suggest that somewhat different language be employed (e.g., "proposed order") and that the word "final" be inserted prior to "order" in proposed subsection 8e(e).

In a related vein, we believe the use of the term "finds" is troublesome, because it implies that the Commission has made some type of formal determination that may have collateral consequences. To avoid connotations of this sort, it might be preferable to replace the word "finds" with a phrase such as "preliminarily concludes."

C. Insufficiency of Procedural Safeguards

A far more serious concern about proposed section 8e is that it provides for a hearing "on the record" in only one instance -- i.e., when the Commission seeks to remove an

exchange officer, director, employee or committee member.³ In all other instances, the provision merely calls for a "hearing," even though this section empowers the Commission to mandate a wide range of actions, including instituting appropriate improvements in its trade monitoring, compliance or disciplinary systems, employing additional staff, upgrading or reconfiguring existing systems, deploying new systems or suspending dual trading. The actions mandated under this section could thus entail enormous costs, require significant alterations in the manner in which an exchange conducts its business and dictate dramatic redirections of an exchange's time and resources.

Because the Commission has typically conducted its "hearings" on an informal basis, often with only written submissions and no opportunity for oral testimony or argumentation, we are deeply concerned that the Commission's ability to dictate sweeping changes in an exchange's operations would be subject to only minimal procedural checks. Although we can understand the sponsors' desire to swiftly remedy perceived market deficiencies, we believe it is extremely dangerous to give any agency -- no matter how well-intentioned or how expert -- virtually unbridled discretion to mandate costly and far-reaching changes in an industry. Rather, we believe that appropriate procedural safeguards are essential to ensure that this discretion is not abused.

We therefore believe that, if an interim order that could entail substantial costs or have a significant effect upon an exchange's operations is issued, the affected exchange should be accorded the full due process rights of a hearing "on the record." Such a hearing would help to ensure that the Commission's actions are fair and reasonable and would also help to assure the right of the contract market to a fair and adequate hearing in the event an appeal is taken to a Court of Appeals.

However, to allow the Commission to focus its resources on situations where they are truly needed, deficiency orders that entailed insubstantial costs or had a minimal effect on an exchange's operations could be issued in a more summary fashion. In that way, orders that did not have major consequences for an exchange's operations could be implemented very quickly, while orders with far-reaching repercussions could be given the careful attention they require.

D. Burden of Proof

Under proposed subsection 8e(b), the Commission may issue an "interim order" if it finds, at any time, that a contract market "has failed to demonstrate" that certain statutory standards are being met. (Page 7, line 17.) This implies that the exchanges have a burden of proof before an interim order issues, even though no procedure has been provided to make any type of showing on this subject. We believe that the words "has failed to demon-

³ When a hearing on the record is afforded, an affected party is entitled to: (i) notice of the hearing; (ii) an opportunity to participate in the hearing; (iii) an impartial decision-maker (i.e., one who has not taken part in the investigative phase); (iv) the right to appear with counsel; (v) the right to present oral and written evidence and to conduct cross-examination; and (vi) the compiling of an exclusive record on which the decision shall be based.

strate" should be deleted. Furthermore, we believe fairness dictates that the Commission bear the burden of proof in any hearing preceding the imposition of a final order. This appears to be the approach the Committee has taken with respect to the removal of exchange personnel, and we believe it is equally essential when a substantial amount of money or a significant degree of market disruption are at stake. We see no reason why the Commission should bear the ultimate burden in one case but not in the others. (At a minimum, the Commission should be required to make a prima facie case for its proposed order at this stage, even if the burden then shifts to the affected exchange.)

To provide added safeguards in this context, we also would recommend that the ability to issue a final order in connection with such a proceeding should not be delegated to the Commission's staff. Although authority to issue interim orders could be delegable, we believe the "double check" of Commission review is essential before such an order becomes final.

E. Standard of Proof

To ensure that the procedural protections available to the exchanges have genuine meaning, we believe it also is essential to modify, to some extent, the standards against which the appropriateness of an interim order is measured. In particular, we believe the hands of the exchanges will be effectively tied if they must use an "arbitrary and capricious" standard to challenge the methods used by the Commission to assess the effectiveness or accuracy of exchange audit trail systems. (Page 13, line 9.) Their hands would be tied, too, if particular proposed corrective actions or the timetables proposed by the Commission in its interim orders could be challenged only on the ground that they are "arbitrary, capricious, or an abuse of discretion." (Page 13, line 14.)

These terms impose a very high standard that is extremely difficult to overcome; and virtually any proposed action, timetable or method would consequently pass muster on this basis, no matter how unreasonable or unrealistic. This standard is normally applied only in an appellate context, after the parties have had a full opportunity for a hearing on the merits, and it is consequently completely inappropriate for the initial phase of a proceeding. Indeed, in light of its stringency, this standard would permit the Commission to mandate, with impunity, all but the most far-fetched "corrective actions," and the exchanges would have virtually no ability to question the wisdom of those "marching orders."

We accordingly believe it would be more appropriate to judge these matters on the basis of their reasonableness and cost/benefits. Indeed, we find it difficult to believe that the Congress would want the Commission to mandate corrective actions under its section 8e authority that would entail greater costs than they would accrue market benefits.

F. Judicial Review

Proposed subsection 8e(f) (page 14, line 3) provides that a final deficiency order issued by the Commission may be reviewed by a United States Court of Appeals "in the same manner and under the same terms and conditions as are provided in Section 8a(9)." Section 8a(9) of the Act was crafted for appeals with respect to emergency actions ordered by the Commission and accordingly affords a very narrow avenue of appeal. In particular, that sec-

tion precludes a court from issuing a stay of the Commission's order unless the court determines, after a hearing, that the agency's action was "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law." This provision is inappropriate for the review of Commission actions that have no relationship to market emergencies. Although we can understand the sponsors' eagerness to remedy certain commodities trading abuses, those abuses do not constitute the sort of market "emergency" that justifies dramatically truncated procedural protections for the contract markets.

G. Dual Trading

Proposed subsection 8c(c) (page 11, line 5) provides that "within 1 year after the date of enactment ... the Commission shall suspend the privilege of dual trading on each contract market, pursuant to an order issued under subsection [8e](b), unless the Commission finds, as part of the first assessment made of such contract market, that the contract market has failed to demonstrate that" its trade monitoring system "fully" satisfies the statutory standards or that there is a substantial likelihood that a dual trading suspension would harm the public interest. As this provision contains one too many negatives, it was presumably intended to read "if the Commission finds," rather than "unless the Commission finds."

Additionally, to clarify that a suspension would not become effective prior to the point at which the Commission's order becomes final, we believe this provision should be amended to read: "pursuant to a final order issued under subsection (d)."

To assure that any such suspension is not unduly harsh, we would also recommend that the Commission be specifically directed to create limited exceptions for dual trading designed to effect spread trades or to correct errors and for dual trading that is specifically authorized by a customer. In addition, a reasonable phase-in period should be mandatory.

Finally, to assure that a suspension does not remain in effect for an indefinite period of time, the legislation should contain procedures pursuant to which an exchange can demonstrate to the Commission that its audit trail systems have been modified to meet the requisite standards or can otherwise demonstrate that the suspension is no longer appropriate.

H. Feasibility of Monitoring for Dual Trading Violations

Proposed subsection 8e(b) specifies that an interim order may be issued if a contract market has failed to demonstrate that its audit trail system is capable of detecting "all types of violations attributable to dual trading" and "to the full extent feasible as determined by the Commission, all other types of violations ..." (Page 7, line 24; emphasis added.) It is unclear why the feasibility of monitoring for violations is not an overriding consideration in the case of all types of violations, including those attributable to dual trading. We would therefore suggest that this provision be modified to provide that:

... (B) such system is capable of and is being used to review data on transactions on a regular basis to detect violations

related to making trades and executing customer orders on the floor or subject to the rules of such contract market, including, to the full extent feasible as determined by the Commission by rule, all types of violations attributable to dual trading and all types of violations involving the making of trades and the execution of customer orders.

III.

Section 203

A. Oral Orders

Proposed subsection 4c(g) (page 16, line 22) would ban the placing of oral orders on contract market floors for "member-for-member trades" unless the orders are made "pursuant to rules that the Commission adopts and certifies to Congress will require standards and procedures designed to ensure that such orders are not used to facilitate violations of this Act." To give the Commission the opportunity to promulgate such rules, the effective date of this ban would be deferred until 270 days after enactment.

Although the sponsors presumably intended to limit this ban to trades done by one floor broker for another exchange member on the floor (i.e., to so-called "Type 3" trades), the term "member-for-member trades" is not a recognized term for such trades and the scope of this provision is accordingly unclear. (As currently written, for example, it could be read to encompass instances in which a member who is off the floor calls down to the floor to place an order.) We therefore believe the Bill should be amended to clarify the sweep of this provision.

We are also concerned about the fact that this provision would direct the Commission to "certify" to Congress that any rules it adopts in this area "will require standards and procedures designed to ensure that such orders are not used to facilitate violations of the Act." We believe this certification requirement is unduly stringent and will have a chilling effect on the Commission's ability to adopt rules in this area, even in instances in which the Commission would concede that permitting certain transactions (e.g., inter-market spreads and options offsets) would have substantial benefits for the marketplace. We believe the Bill should require only that the Commission adopt rules that it "reasonably believes" will deter abuses in this area and report this fact to Congress.

As an alternative to imposing a statutory ban on "member-for-member trades" unless the Commission completes a rulemaking in this area within 270 days, the Bill could merely direct the Commission to promulgate, within a specified period of time, rules governing this area. This approach would have the advantage of ensuring that vital hedging and inter-commodity spread transactions will not be automatically banned if the Commission fails to meet the 270-day deadline. This approach also would have the advantage of preventing any confusion from arising with respect to the types of transactions that are subject to such a ban.

IV. Section 301

A. Broker Associations

Proposed subsection 4j(3)(A) (page 17, line 14) would prohibit a floor trader or a floor broker from making a trade or executing an order for a customer if he knows that the opposite party has a relationship with him as a partner, employer, employee or co-worker, unless the Commission has adopted rules that it "certifies to the Congress require procedures and standards designed to prevent violations of the Act" attributable to this type of trading.

We believe there is no justification for imposing an across-the-board ban on executing a customer order against orders held by affiliated persons. In particular, the provision, as drafted, would prohibit customer orders from being executed against other customer orders if those orders are held by affiliated brokers. In view of the fact that a single broker is currently permitted by Commission regulations and the rules of almost every exchange to cross an order between two customers (provided that specified procedures are complied with), there does not seem to be any reason to prevent a broker from executing a customer order against the customer order of an affiliated broker. Moreover, in a thinly traded market, such a ban could deprive a customer of the best execution of the order.

A better way to handle any perceived problems in the area of trading between affiliated brokers would be to require the Commission to adopt regulations defining "broker associations" and governing this practice. Although it is true that the Senate Bill currently gives the Commission the authority to adopt regulations approving this practice and delays the effective date of this provision for 270 days to permit this to occur, the fact is that this practice would be banned on an across-the-board basis unless the Commission can act within this time frame, a result that could severely and unnecessarily disrupt the markets. (If the Committee determines not to follow this alternative approach, our previous comments with respect to the Commission's need to "certify" to Congress (page 14, supra) are also relevant in this context.)

V. Section 401

A. Abstention from Board Participation

Proposed subsection 5a(17)(B) (page 20, line 24) would require contract markets to adopt rules requiring Board and committee members to abstain from participation in voting and confidential deliberations on an issue if the Board or committee member (or an affiliated person) is, to the knowledge of such Board or committee member, "a specific and actual party in interest to the issue before the board." Although this provision was most likely intended to apply only to specific disputes or business dealings directly involving the Board or committee member (or an affiliated person), it is not expressly confined to situations of that type. We therefore believe it is desirable to clarify the specific focus of this provision in the Bill's legislative history.

B. Exclusion from Board for Appropriate Period

Proposed subsection 5a(18) (page 22, line 14) would require contract markets to adopt rules providing that "no member found ... to have violated this Act or any other provision of law that would reflect on the fitness of the member to serve in a fiduciary position may serve on any contract market oversight or disciplinary panel for an appropriate period (as defined by Commission rule)." Although this concept is laudable, we believe the language of this provision is overly broad, as it would have the effect of excluding members from exchange service merely because they had committed a technical violation of the Act, and is unduly vague, as the types of violations that "reflect on the fitness of the member to serve in a fiduciary capacity" are unclear. In addition, the term "oversight panel" is a new term, and it is unclear how it would apply in the context of exchange governance.

To address the first problem, we would suggest that this provision be amended to read as follows:

"... have committed any violation of this Act, or any other provision of law, that would reflect on the fitness of the member to serve"

To address the second, we would suggest that the Commission's rulemaking authority in this area be expanded to encompass, not merely the "appropriate period" for exclusion, but also the meaning of the phrase "reflect on the fitness of the member to serve in a fiduciary capacity." Additionally, the Bill should clarify the meaning of "oversight panel."

In a related vein, we believe the Bill should give the Commission the authority to promulgate rules with respect to "meaningful representation" of "a diversity of interests" on exchange boards and that this authority should include the ability to address situations in which an exchange is unable to fill a vacancy in a particular category.

C. Obligation to "Ensure" that Inside Information is Not Transmitted

Proposed subsection 5a(17)(C) would require contract markets to "ensure," "when adopting any contract market rule or order that is likely to affect prices in any actively trading contract market," that any party with access to material nonpublic information about such deliberations is prevented from trading in a manner that takes improper advantage of such information or from transmitting such information to any other party (except as necessary for the performance of official duties). Although we support this concept, the actual language of this provision is too categorical. Although an exchange can utilize its best efforts to prevent inside information from being used or transmitted and can take action against any person who is found to have committed an abuse, it has no way to "ensure" that such use or transmission will not occur.

VI. Section 601

A. Expansion of Antifraud Liability

Proposed Section 601 (page 27, line 6) would make mere negligence a sufficient basis for recovery under section 4b of the Act, a section which makes it unlawful for any person to engage in various types of fraudulent activity. For example, if this provision is enacted, a futures commission merchant ("FCM") or floor broker could be held liable merely for negligent misrepresentations, rather than only for intentional misrepresentations or for representations made in reckless disregard of the facts. The predicate for such a substantial lowering of the standards for recovery under Section 4b is unclear, and we believe the Committee should be very cautious about making this change.

We would note, in this regard, that raising the penalties associated with commodities violations and lowering the standards for finding liability are likely to trigger a flood of commodities claims and dramatically increase the costs of engaging in a commodities business. We fear that, if penalties become irresistibly high and the standards for assessing liability become unreasonably low, the only segment of the industry that is likely to flourish will be the commodities bar. Indeed, in light of the relatively low profit margins associated with the retail brokerage business, a dramatic increase in the risks associated with that business may cause many brokers to either close their doors or provide brokerage services only to institutional customers.

VII. Section 602

A. FCM Liability for Floor Broker Actions

Section 602 (page 27, line 19) would add a new subsection to section 6d of the Act, making an FCM that "selected or contracted with" a floor broker to conduct a trade or execute an order liable for any award of damages proximately caused by any violation in the making of such trade or order. Moreover, that section would subject an FCM to punitive or exemplary damages if it "willfully and intentionally failed to exercise due diligence in selecting the floor broker or monitoring the execution of the order."

There is great concern in the exchange community that the prospect of secondary liability and punitive damages could dramatically restructure the floor community by driving FCMs to rely exclusively upon their own employees to execute trades. Concomitantly, it could make a floor broker unemployable if he has ever been sanctioned by the Commission or by an exchange, even if the activity in question had no bearing upon the broker's ability to handle customer business in a responsible fashion. Functioning as an independent floor broker has long been a way in which individuals who were hardworking and ambitious, but had relatively little capital, could start their own small businesses, and it would be unfortunate to arbitrarily and needlessly foreclose this avenue of opportunity. We therefore believe that this provision opens up the proverbial "Pandora's Box" and that the Committee should be extremely cautious about adopting it.

At a minimum, the circumstances in which a broker will be found to have "willfully and intentionally failed to exercise due diligence" should be clarified, and a "safe harbor" should be created pursuant to which FCMs can be assured that they will not be exposed to punitive damages. Such a "safe harbor" could, for example, provide that, if a floor broker's registration with the Commission is in full force and effect, an FCM will not be deemed to have "willfully and intentionally failed to exercise due diligence" merely because the broker had, at some previous point in time, been found to have violated some provision of the law or of an exchange's rules. Such a safe harbor would place the burden of determining a floor broker's "fitness" to function in that capacity precisely where it belongs -- on the shoulders of the Commission -- rather than forcing FCMs to "second guess" that agency's regulatory judgments.

When an effort to clarify the meaning of "willfully and intentionally..." is made, we believe the standard for assessing punitive damages should be made extremely narrow, to assure that the Bill does not dramatically increase the incentive for strike suits. (Such liability should, for example, be limited to situations where the FCM had specific knowledge that a floor broker should not be trusted with customer orders, but nevertheless continued to utilize that broker.) To be consistent with other portions of the Bill and to assure that an FCM's exposure isn't completely open-ended, this provision also should be amended to provide that punitive or exemplary damages cannot exceed two times the amount of the actual losses.

Moreover, we believe that, if an FCM has instituted appropriate procedures and controls regarding the selection of brokers and has faithfully adhered to those procedures, it should be free from any liability for the floor broker's wrongdoing. We believe it is patently unfair and potentially damaging to the markets to impose a "strict liability" concept on FCMs that have acted as conscientiously and responsibly as possible.

VIII.

Section 603

A. Provision for Punitive and Exemplary Damages

Proposed amendments in section 5(a)(11) would require contract market arbitration procedures to provide, to the extent appropriate, for payment to the customer of punitive or exemplary damages in addition to losses proximately caused by the violation, in the case of claims arising from a violation in the making of a trade or the execution of an order on the floor or subject to the rules of the contract market. (Page 29, line 9.) To assure that such awards are not excessive and to make this provision consistent with other provisions of the bill, we believe that punitive or exemplary damages should be limited to cases where the violation was "willful and intentional" and should not exceed more than double the amount of the actual losses.

Senator HARKIN. Thank you all very much.

I have not asked any questions. We have to leave. I do not think I can be back here right at 2:30. I may not be back until after this panel is finished, because of some legislation on the floor.

I have one simple question, and we can have a yes or no answer. Senator Eagleton, in his opening remarks, said that the open outcry system should be compared to the quill pen and Ebenezer Scrooge and said it should go by the wayside and we should go to a straight electronic trading. How say you, Mr. Mahlmann?

Mr. MAHLMANN. Senator, I say unequivocally no.

Senator HARKIN. Mr. Melamed.

Mr. MELAMED. Absolutely not.

Senator HARKIN. You have to have the open outcry system?

Mr. MELAMED. Absolutely.

Senator HARKIN. Mr. Guttman.

Mr. GUTTMAN. Open outcry now and for the next 100 years.

Senator HARKIN. Regardless of technology?

Mr. GUTTMAN. Technology included, alongside open outcry.

Senator HARKIN. Mr. Fink.

Mr. FINK. Firmly no, Mr. Chairman.

Senator HARKIN. I just wanted to find out what you would say. Thank you all very much.

The committee will stand in recess until 2:30.

[Whereupon, at 12:50 p.m., the committee was in recess, to reconvene at 2:30 p.m., the same day.]

AFTERNOON SESSION

Senator KERREY [presiding]. The committee will come to order.

I am just going to open with some followup questions provided to me by the Chair, since he was here and I was not for your initial presentation. The questions are in regard to the audit trail and your concern both for the cost of developing the technology and the implementation of that technology and the time lines that are going to be required.

The question is whether or not you are going to be able to deploy the systems marketwide within the 3-year period required by S. 1729, and what I am looking for are some responses specific to that 3-year time line for the audit trail that is required in the legislation.

What do you think, Leo?

Mr. MELAMED. I believe we can do it. If you are talking about technology that includes the hand-held recordation device (AUDIT—Automated Data Input Terminal), I believe our goal is to develop this device within a year. I believe this device will go a long way toward solving most of the requirements you have before you. Now, no one can guarantee within a year and I cannot make it that specific, but we believe we can achieve it within that timeframe.

Senator KERREY. You think you can do it within a year?

Mr. MELAMED. You are talking about the hand-held device?

Senator KERREY. Yes.

Mr. MELAMED. That is our goal.

Mr. GUTTMAN. Senator, as you know, the New York exchanges are cooperating on this hand-held technology. We have been at it for a year and a half and, after a year and a half, it is still a project and the goal of 1 year or 3 years is very admirable. My fear is that if we lock ourselves into a period of time and we cannot accomplish, with all good intentions, that a bill will automatically kick in and, as such, the intended effect of the provisions of the bill will not be served.

I am not a technical expert. Our technical people say that there is technology but the technology is slow at this point. It is working at 4 megahertz and it is something more in line with something like 15 megahertz is necessary. We must also choose between infrared and cassettes. There are a lot of technical aspects of this hand-held technology which we are all pursuing, but to lock ourselves into a particular timeframe, we have problems with. But if we can get it done in a year, as Mr. Melamed feels, or in 3 years, well, we are going to be right there with it.

Mr. FINK. Senator, I would be less than truthful if I told you for sure that we were going to be able to comply with the requirement within 3 years or within 1 year. As you know, we have done some work at COMEX, along with the other New York exchanges, on the development of a hand-held device, but we do not honestly know whether that device will work in a hot-pressured trading environment. We have put together a skeleton of an instrument that has a little bit of software and that possibly has some hardware associated with it, but whether it is feasible in a full-trading environment is not entirely clear.

It is also not entirely clear, as long as we are on the subject, that the device will be able to meet the requirements that are satisfied in the bill, as we point out in supplement to our written statement. We have some confusion over the issue of what exactly the bill is intended to mean by the word "independent" and whether the input can be provided by the person who is physically holding the device or not.⁵

Finally, the last issue is we are not entirely sure that we can afford it. We have spent so far on the development of the hand-held device, to bring it to a very primitive stage, seemingly a small amount of money, about one-quarter of a million dollars, but there are other costs associated with that. We have no idea what part of the iceberg these costs represents. We have had estimates from some of our vendors that suggest that the cost of the hand-held device could be something along the lines of \$2,000 a unit, so the actual implementation for our exchange would probably mean that, if the thing is successful, we would probably be spending something along the lines of \$2 to \$3 million. For an exchange that has \$5 or \$6 million in its bank account, that is a very big number and a very risky experiment, so we are not sure.

Senator KERREY. You may have to incorporate as a savings and loan, with that kind of money. [Laughter.]

⁵ See p. 408.

Some of you have been working on this technology anyway, have you not, for the purpose of doing a better job of matching trades and perhaps achieving some cost savings?

Mr. MELAMED. You are quite right, Senator Kerrey. We have been working on the technology for a broker's station that would provide the broker with a tool of this kind. This would be in a stationary form, and would aid as a clearing mechanism. Thus, we get closer and closer to an online clearing concept. The Board of Trade is developing a similar station. We are working to join our TOPS and their EOS systems, which are order routing to that kind of a station. So, all of this has been in the works for a long time.

Actually, were it not for the investigatory thrust which pushed us to bypass these stations and move toward the hand-held device, which was a priority secondary to the stationary broker stations, it would have been better to have the stationary terminal in place and then go to the hand-held. What we did was switch priorities in our attempt to respond quickly to this investigatory development. Either way, we are working our way toward that kind of technology as an aid to open outcry.

Senator KERREY. How does the Board of Trade regard the time line?

Mr. MAHLMANN. Senator, as Mr. Melamed indicated, it was I believe less than 2 months ago that we jointly gave a press release and said that both exchanges would commit jointly \$5 million to the development of an electronic trading card that at this time could not be bought off the shelf. We are going to have to commission the development. Both exchanges have an expert technology team assigned to the task. We have just come up with guidelines for specifications. We should have requests for proposals out by November. We hope the technology can be developed custom-made for us within the year.

However, after that, you then have to talk about an implementation phase, you may have to change the technology available on our trading floors, meaning potential rewriting. We do not know that yet, what requirements of time that will entail. We are very hopeful to meet the 3-year deadline, but we would very strongly support that the CFTC and the GAO, which have both been commissioned to make an evaluation of the process, that if they deem that 3-year date unfeasible to implement, that that extension then be granted and be proscribed in the bill right now.

Senator KERREY. As I understand it, the larger exchanges, you and the Merc are willing to share technology with some of the smaller exchanges who might otherwise find the costs prohibitive?

Mr. MAHLMANN. We have made public statements, and we will stand by that, that between the two of us, we are going to develop the system, we will make it available to the other exchanges.

Senator KERREY. Do you want to comment on that, Mr. Fink?

Mr. FINK. Not only has Mr. Mahlmann made public statements, but he has made private statements to that effect. He and I have had a conversation on the telephone to that effect. The Board of Trade and the Merc have both expressed their willingness to share information. COMEX, in turn, has expressed a willingness to share the information with the Chicago exchanges, and we hope somehow all of that comes together to move us toward a better technology.

Senator KERREY. Our understanding was that that would relieve some of the anxiety about the prohibitive nature of the cost. Is that not true?

Mr. FINK. It may. It is not entirely clear if the systems will definitely be compatible. There are a lot of differences in the operations and I am not entirely sure that a system that works well on the Chicago Mercantile Exchange will work well on the Coffee and Sugar Exchange.

Senator KERREY. The development of this requirement, by the way, was based upon many of the concerns that were expressed earlier today by Senator Eagleton, and the dominant thing that we have tried to focus our attention on is the audit trail. It is one thing that gives us some sense that the trading is done properly, though I am sure some of my colleagues on this committee understand the business of trading much better than me. I have a base level knowledge that is minimal and I have used the market before, but I certainly do not understand what goes on on the floor nearly well enough to be able to get into the details of rules and regulations, with any great comfort, so the audit trail gives us some assurance.

You are going to have to provide us with additional input, because what we tried to do is to say that we want that audit trail improved with new technology, but we also understand that there is a possibility that that technology may not be employable by the deadline that we have set. That is why we have also asked for the GAO to advise us and we have provided for ways to extend the timetable as may be reasonable and justified.

I would be very surprised if the committee is not pretty strongly and unanimously supportive of the audit trail provisions. There are maybe some other sections of the bill that are more controversial, but I think there is going to be a great deal of interest in establishing a deadline, and so what I would ask the four of you to do, as we develop this thing, is to make sure, in as specific a way as possible, to give us some indications as to what we can do to make certain that we do not impose excessive costs or other sorts of things that are going to be unworkable for you and the exchanges.

The chairman also has a question on the service fees, and I will just read it to you. In 1982, the futures industry strongly opposed the user fees of 12 cents a round-turn trade, charging that this would be onerous and cripple the then new National Futures Association. The fee was defeated, but the NFA then imposed its own fees of 28 cents per customer trade, totaling about \$25 million a year.

Since then, rather than suffering, futures trading has prospered, volume has doubled, and the question then is why should we believe that service fees under S. 1729 would cripple U.S. competitiveness, when the record under much larger NFA fees is exactly the opposite.

Mr. MELAMED. Senator Kerrey, I do not know if "cripple" is perhaps an overstatement, but we are very cost sensitive in a competitive way. All these provisions tend to make us less competitive. It is not a question of whether it cripples or simply diverts some of the business that could be done cheaper elsewhere, but while it

may not cripple us, it will certainly lose us some portion of that business.

It may happen as the result of a regulation or fee structure imposed that may or may not be necessary to the process. We are living in a very competitive world, where everybody is watching every penny.

In 1982, we confronted this issue. At that time, as you know, there was no National Futures Association. This industry agreed with the Senate to take a certain amount of the compliance burden away from the CFTC by assuming those burdens themselves. In that agreement with the Senate and Congress, in the bill created at that time, we agreed to create a National Futures Association. I believe Mr. Wilmoth, president of the association, will later testify that we agreed to tax ourselves in one form or another to pay for those compliance costs and thereby remove some of the burdens from the CFTC and the taxpayer. We did all of that, carried out our bargain, and we presently tax ourselves something like 20 cents per trade.

Now, I grant you that our business has continued to grow, in spite of that tax. But the point I am making is that we carried out our end of the bargain. The NFA provides a service that we pay for that has been complimented by most of those Federal agencies that have reviewed its service. The CFTC has stated that the NFA does a very fine job and that it does help carry this burden. We, in fact, carried out an agreement that we had with the Congress with respect to service fees.

Senator KERREY. I am going to yield here in just a second. I just presume to know what the committee itself, as a group, is thinking, but as I sense the environment right now is best summed up with reference to Senator Eagleton's presentation this morning, who said, as a member of the Merc's Board, that we ought to either strengthen the CFTC with additional resources or we ought to shut it down, one or the other. Those are the extremes, and assuming that you would prefer the first over the latter, we need to find some revenue source to pay for it. I am aware that the local traders pay nothing at all on trades, and what I am suggesting to you is that you are going to have to work with the committee, if your objective is, like ours, to strengthen the CFTC, to look for a satisfactory source of revenue to pay for the additional regulatory strengthening.

Senator Lugar.

Senator LUGAR. Thank you very much, Mr. Chairman.

Let me say first of all, I appreciate the detailed papers submitted by each of the witnesses. I have read them and I think they are very important as backup materials and they will offer each one of us and the staff a great deal to work with.

I want to raise questions about three important issues that were raised in each of the four papers and simply try to obtain more from your oral testimony on these issues.

First of all, the argument is developed in greater detail in the backup materials from the Chicago Board of Trade concerning the value of the open outcry system. As I read that material—and it is reiterated in other statements—the point is made that the open outcry system is the unique feature of our futures system that dif-

ferentiates it from others. Unless I misread the argument, which is one that I had not seen with this intensity before, the point is that the open outcry system accommodates more trading, greater volume of trading and does so somewhat more efficiently. And that if you were forced to go to a purely electronic system, this could slow down the number of orders that could be taken.

A contention is made in one of the four papers that an electronic system might, in fact, give greater certainty in terms of orders, timing, sequencing, customer bills and what have you, but that the sacrifice of getting this degree of accuracy, and, I might add integrity in the system, would be to sacrifice the competitive nature of open outcry and thus make our system less competitive with those of other countries.

Are contending that the electronic systems, which you pointed out originated from the genius of the American futures markets, are simply not at a point of sufficient reliability, perfection or comprehensiveness? Clearly most of the progression of invention in America has been at least due in some part to the fact that computerized electronic systems have become inordinately more efficient year by year.

One of the great aspects of our competitive position with regard to the Soviet Union or anybody else is the power and authority of our computer systems, so that the logic at least of some of us on the committee lead us to believe that computerization is probably a course that would also serve the futures industry very well. Can any of you address this general philosophical point? Clearly I want to know exactly what is the uniqueness of open outcry, or is this simply a contention that it is the best system for the moment, with possibility, that as developments come electronically, those systems might supersede open outcry?

Mr. MELAMED. Senator, I will answer for the Chicago Mercantile Exchange. My answer may differ somewhat from the other exchanges. I believe there may be shades of difference between us.

I would like to point out, first of all, that, as I averred in my opening remarks, the idea of electronic trading came from within the industry. It was a recognition of the way the world was going in terms of globalization and the international competition we face.

We felt this could best be met with an electronic system that could then pick up after the open outcry session ends. We recognized that we must compete internationally on a 24-hour basis, because the markets are being used on a 24-hour basis. We recognized that the minute we close our door, the next market opens its door and that we could lose our market share and maybe even our market through that door. So how do you compete best? We thought to compete best we would use the technology that either would soon be or is currently available and with it build an international system such as what we call GLOBEX. When we did that, we recognized and very carefully understood that the economic engine that open outcry represents must be utilized to assure that GLOBEX will succeed.

If we did not have the success of the open outcry system, if we could not depend on the amount of open interest that has evolved because of open outcry during our day's session, then I would tell you that I do not know to what extent GLOBEX will succeed. It is

because what we have done is integrated with open outcry. We literally made one to work with the other. Without the economic engine of open outcry that produces the kind of liquidity and open interest and success of our markets, GLOBEX in itself is a big question mark.

So, to rush us in an artificial way to do away with that which acts as the economic engine for the success of the whole thing may endanger the entire system. That is the view of the Chicago Mercantile Exchange. I do not believe that open outcry need exist for 100 hundred years. I differ with others about that. I do not even know whether it will exist 25 years from now. None of us have that kind of crystal ball.

But I would like to see it evolve naturally as a consequence of evolution of the markets themselves, proving one against the other. I would certainly not urge this Congress to push us to artificially do away with the one thing that is central to the success of this national resource called futures markets. No other markets in the world are as liquid as ours as a result of the open outcry process.

Senator LUGAR. Well, let me say that the Congress is not intent upon driving the exchanges into an uncompetitive position. Quite the contrary, those of us who take an interest in this issue, believe that this is an extremely important industry, that the future of it is at stake.

I am not going to address the problems of the futures industry in emotional ways, but I would say that one reason for the thorough examination of the open outcry system is that there is the perception on the part of some of us—and I am one of them—that it allows for potential abuses. Now, the question will be raised, how many and to what extent are persons culpable under this system as opposed to others. The testimony we have had from GAO and others indicates that gaps in reporting allowed certain persons to take advantage of customers. This has led to a situation where customers around the country and constituents of ours are questioning the system. This is why we are in the process of examining what is required to restore customer confidence. The exchanges have been working inordinately hard to do that and we appreciate their efforts.

The question recurs in large part because we have had expert testimony by GAO and others that an electronic system apparently gives an absolute sequence of events that cures at least some of the alleged abuses that are a part of the indictments, or at least some of them.

Now, it seems to me the philosophical position is—and it was raised by one of you—that integrity is a very important part of the system. Efficiency and volume of trade, and international competition are all other important components, and I believe we are all mindful of these things.

However, to return to the question of whether the electronic system does provide the integrity aspect, and how market efficiency under open outcry might be adversely impacted. Your argument, Mr. Melamed, is that the judgment may still be out for many years. However, at the same time you have open outcry. I believe that you even see a sort of corporate fellowship that comes from open outcry. Your written testimony indicates a benefit from the

congregation of persons that generate interest and excitement, and maybe your point is that you need to have sort of this focal point or excitement in order to generate trades. If you had just an electronic board, without the corporate fellowship of the traders, you would not have the same thing. To me this is an interesting argument and one we would probably need to pursue in greater detail.

We are at the point, where critical doubts have been raised in terms of the audit trail and the manipulation of time records by persons who have been involved. To the extent that it can be corrected, it seems to me this committee, the Congress and you, have the responsibility to try to correct the situation. This is why I hope that this hearing or the whole debate does not turn into an adversarial proceeding in which, on the one hand, we have the electronic advocates and, on the other hand, we have the open outcry supporters. This would be bad because at some point the public as a whole is going to be left in some doubt about the integrity and certainty of the system.

When you have testified that you feel that the Congress is moving in an inordinately rapid pace on audit trail changes—one of you suggested the 3-year deadline be removed or even 3 years plus the thought of greater flexibility. It seems to me that a certain timeframe is need to provide the public with some degree of certainty. The public sees itself as jeopardized for the next 3 years under the Senate bill as it now stands, and it seems to me a specific framework is in the best interests for the industry as well as the Congress.

For any of you, in reviewing the whole timing situation, what is the parameter in which change or a greater degree of certainty ought to occur?

Mr. MAHLMANN. Senator, if I would be permitted to use an analogy, I would say that the car is a very useful and very good instrument for U.S. users, and I would submit to you that the car in the hands of a drunk driver is a deathly vehicle, but we should not eliminate the car because we have a drunk driver, or 10, or many.

We as exchanges have found no better system than the open auction outcry system today, and we fully support the spirit of the Senate bill, that the drunk driver or the violator should be detected, should be prosecuted, and should be punished, swiftly and severely. But to do away with a 140-year working business—and, really, if you ask yourself, as a businessman, it is a working business—and automatically by dictate or by fiat say 3 years from now this is going to be a better business, when that is not proven today, then, as a businessman, I think it is the wrong approach, because there is no computerized trading system out there at this juncture—yes, there are in Tokyo and yes there are in Switzerland, but I submit to you that none of them could have done on Sunday night almost 300,000 Treasury bond contracts, as I incorporated in my opening statement, in the efficiency, without a breakdown, as we did this past Sunday. Those systems are not available.

We are trying to develop a system for after-hours, but whether that will be here and successful and replace the open outcry market, I think the future will tell.

Senator LUGAR. Let me just interject for a moment, others have expressed this as well, and I will reiterate it, that we would not be

at this place to begin with if there was total confidence on the part of this panel, our committee, that either the exchanges were in control of their membership or the CFTC had been rigorously sufficiently in its oversight. We really come along, as all of you have suggested we should, on behalf of the public and see a good bit of disarray in the management of the exchanges, as well as, from time to time, in the management by the CFTC.

Now, the ultimate end of this exercise, I suspect, is going to be the end of the CFTC and maybe the end of this committee worrying about it at all. You know, Senator Leahy and I sort of started our Senate careers worrying about the CFTC and FIFRA legislation. We were sort of assigned these issues because they are complex and because others did not want to handle them.

At our last round of hearings on reauthorization, we left completed action with some confidence that the industry was going to take control, devise a much better audit trail and get a good handle on things. However, this really did not turn out to be, in our judgment, the case. We are not really confident, as has been expressed today, that the CFTC has a handle on it, either. This is why it is becoming truly a fundamental issue.

Now, it may be that the industry itself is perfectly confident in what it is doing. However, that is only one side of the equation. From the standpoint of the public perception of what is going on, it has not been a good year on futures exchanges. That is why we really have to come to grip with the question both of efficiency as well as the integrity of the audit trail. One of our primary concerns is with the outside customer, who comes from a farm in Indiana or Nebraska, who phones in an order and wonders really how he is being dealt with at that point by persons who are sophisticated and in a position to, if they wish, to manipulate things.

Now, let me just raise one question to focus this again. We have had a lot of testimony on dual trading and each of you have addressed that question. It is sort of a focal point of controversy. Most of you have said that dual trading ought to continue, and yet in a common sense way, as we visit with the press or with constituents about this, people ask: how can a person who is dealing for his own account deal fairly with a customer in the same way? Well, your response is that we are all professionals and have traded in this manner for years, with a great deal of integrity, so what is so troubling about that.

Well, there should not be anything troubling about that, but there is evidence that some persons dual trading have used their customers' orders for benefit of themselves. Now, one can say that there only was small amounts of money involved, and that out of all of those accumulated violations, it did not amount to a whole lot in terms of a percentage of the total trading volume. However, the fact that such abuses allegedly did occur, has created a perception that dual trading, essentially having two masters, is not a very good idea.

All of us understand that liquidity in many markets may depend upon the generation of these trades in dual trading. This is why the House called for the elimination of dual trading at a certain level, preserving liquidity at lower levels. But what is the defense philosophically of dual trading, how do you make a case to the ordi-

nary person who is listening to this debate and wondering already about manipulation, as to why there should be a continuation of this practice of dual trading?

Mr. MELAMED. Well, I again may differ in some respects with others on this panel. But one must really put dual trading in its perspective, Senator Lugar. Dual traders are everywhere in every part of the financial community, whether they are currency traders or bond traders in the cash market, or securities traders in stocks, or on the New York Stock Exchange or American Stock Exchange, or in banks.

We have dual trading everywhere. I do not know why it suddenly became sort of popular to look at dual trading in futures markets as something different and apart from the rest of society. I do not believe it is.

But if you could tell me, and if the evidence were there, that indeed dual trading is the main source of our problems in terms of violations, then I would subscribe, as you do, to undo it. But, that simply has not been borne out, that has not been the evidence.

While trading has given rise to some violations, and we clearly agree that we have to do something about that, dual trading is not the main source of these violations. And therefore, what we have suggested is, I believe, a very rational solution.

The Chicago Mercantile Exchange is on record as saying that we will make a standard of monitoring the dual trading issue to a degree that ought to satisfy all prudent people. If we cannot meet that standard, we are willing to do away with dual trading, but give us an opportunity to preserve the good that dual trading represents. And if we cannot meet the standard, well then we will agree to do away with dual trading.

I do not believe that is an irrational approach to this very difficult and sophisticated issue.

Mr. GUTTMAN. Senator, if I may add to that, Mr. Melamed spoke very eloquently on behalf of dual trading. But I also think you have to take into consideration the size of the exchange itself. The two Chicago exchanges have approximately 3,000 brokers on their floors. If the administrations of those exchanges feel that they can live or they wish to limit their dual trading, they have close to 2,500, 2,000 other brokers that could pick up the slack and rearrange the business functions.

On the NYMEX, we have approximately 500 brokers on the floor. Those 500 brokers serve a vital function to keep the exchange going. If I take half of those brokers out of circulation, in terms of the liquidity and additional capital that they bring into the efficiency of the marketplace, I am artificially forcing our exchange to cut its volume or cut its efficiency.

So even on the issue of dual trading, it has to be seen exchange by exchange. Yes, there is a perception that dual trading is evil. Yet when we take a look at the indictments out of Chicago, none point to dual trading as the culprit in any of these abuses.

And as such, Leo pointed out very effectively that dual trading, trading for one's own account and handling customer business, is a vital function in our organization. One of our board members recently stuck an NASD regulation under my nose. And, again, the NASD is a self-regulatory organization.

Senator BOSCHWITZ. What is that?

Mr. GUTTMAN. NASD, National Association of Securities Dealers. Where if I might, just by example—and I am not trying to bring out anything that we are holier than they are—they have a situation where it is legal, accepted, where market is 10 bid at a quarter, if a dealer is making 10 bid at a quarter market, and a customer calls up and says I would like to sell 1,000 shares at 10 and an eighth, the dealer still makes his market at 10 bid and a quarter. And if he sells that quarter, he is entitled to hold on to the 1,000 shares in spite of the fact that the customer is attempting to sell 1,000 at an eighth.

So here you have a classic example where the financial community has accepted the dual role of a dealer/principle, et cetera. If you put all this together in an orderly fashion we, in New York and as an institution, feel that dual trading for us is a must.

The CHAIRMAN. Gentleman, I listened to the explanations on dual trading, what works and what does not. Having spent nearly 15 years figuring how the commodity markets work, I think as a Member of the Senate I have a fairly good idea of it. Certainly, I do not pretend to have the expertise of those who deal on it every single day as part of their livelihood.

I would just point out some of the political realities here. I have read through the testimony of all of you. I understand those areas where you disagree and disagree rather strongly with the legislation before us. I think that you should understand, as we have stated before, that the legislation is not aimed at the four people sitting at this table. If we did not respect your expertise and your judgment in these matters, you would not have been invited to be here to testify.

What we are concerned about is the feeling of some within the industry that somehow, if they just hunker down and pull political levers, all this will pass. That is not the situation. There is a great deal of concern by people who have very little understanding of how these markets work. They are concerned about the indictments that have come down. They are concerned about the sudden swings within the market, concerned about items they read, whether it is in the Wall Street Journal or any newspaper. They think that perhaps somebody better go into these arcane markets which are well-understood by the 100,000 or 200,000 people directly involved in them, but not understood very much by the 250 million other Americans.

You have talked about dual trading. I have talked about open outcry, for example, and whether this is an attack on open outcry. S. 1729 is not. I can tell you what would come right after S. 1729 if this does not pass. I realize that there may possibly be some areas of change in the bill, but I cannot think of many. We have worked very hard on this.

The Senate Agriculture Committee staff has talked with virtually everybody within the industry and outside the industry. We have tried to keep everybody posted on what we were doing, and we sought advice and information from everyone. Unlike the other body, we delayed putting in the legislation until we had a chance to go through the process, until we could touch base with a lot of

people, talk to individual Members of the Senate as well as those within the industry and those affected by it.

S. 1729 is not an attack on the open outcry system; it maintains the open outcry system. It maintains the jurisdiction of the CFTC, although I would hope greatly strengthened because I am not confident in the job the CFTC has been doing. I think it should be doing a better job.

As Senator Eagleton mentioned this morning, you cannot legislate motivation. You cannot legislate what one might do under the law. The CFTC, however, in my estimation, does not have adequate tools or personnel or even the laws to work with.

What we have done in this bill is to strengthen the CFTC. We have certainly strengthened the audit trail. We have also preserved the open outcry system, though there were a number of people involved with the development of this legislation who had serious questions—questions that I respected because I respect the judgment of the people who raised them—about the open outcry system.

There is going to be legislation this year. I might tell you that a lot of people feel that if we cannot have the kind of reforms in S. 1729, maybe we ought to take future jurisdiction out of the CFTC and put it under the SEC. Maybe we ought to do away with the open outcry system and require something else. And those people, absent good, strong legislation like this, would probably have a majority going along with them.

I mention this as a political reality. Now, each of you has defended the practice of dual trading today. In S. 1729, dual trading would be barred only to the extent that an exchange cannot police its floor against dual trading-related abuses where the public is protected.

Do you feel that is not an appropriate way to address the question in S. 1729? Does anyone want to try answer that?

Mr. GUTTMAN. I will give it a shot.

The CHAIRMAN. Mr. Guttman.

Mr. GUTTMAN. Mr. Chairman, the audit trail principles are what we govern ourselves under, they are two separate and distinct issues. We have to have an effective audit trail, period, end of story. To tie dual trading in and simply say, well, you cannot dual trade if you are not going to have an effective audit trail indicates the audit trail itself is not good enough for Congress and for ourselves to be comfortable with the issue.

To take the dual trading aspect and use it as a sledge hammer over the effectiveness of the audit trail, I think both of them have to stand on their own merits.

The CHAIRMAN. Well, that is not what I am saying. I am saying that, in our bill, dual trading is barred only when an exchange cannot police the floor against dual trading-related abuses. I think we all know what some of those abuses might be.

If you can police against such abuses, then dual trading is allowed. If you cannot, it is disallowed. Does that really seem so far-fetched?

Mr. Fink.

Mr. FINK. No, it does not seem far-fetched to me at all if you are willing to add just a little twist.

The CHAIRMAN. Go ahead. I thought you might.

Mr. FINK. The little twist is that right now the way the bill is written the practice will be automatically suspended unless the exchanges can demonstrate under standards that are not entirely easily defined, that they ought to retain the practice.

I think the view of COMEX is that, yes, we are willing to lose the practice, as I indicated in both the oral and written testimonies, if the CFTC demonstrates beyond doubt that we have failed to install the mechanisms that are necessary to discover any abusers of the practice.

If we fail to do that, then we are willing to give up the practice. But we feel very strongly that given the importance of the practice and given the likely difficulties that are going to be associated with regaining the practice, that is getting permission to start it again, we feel that the burden of proof should be on the Commission to demonstrate that the exchange is at fault, rather than the other way around.

The CHAIRMAN. Let me do this—and I apologize for having to leave. I am supposed to be on the floor managing a bill right now, and somebody is filling in for me. The matter arose long after this hearing was scheduled. And we did not want to reschedule the hearing because so many people have taken time to come here.

As you know, because of what I had to say this morning, I have spent a great amount of time on this issue and I have a great deal of interest in it. If anybody wants to add to the record, Mr. Mahlmann, Mr. Melamed, Mr. Guttman, or Mr. Fink, please do. I read very closely what you have to say on this. I think your views are crucial to the legislation before us.

Chairman Mahlmann, at a Chicago luncheon speech last week you criticized parts of the bill affecting brokerage firms. I hasten to add that it is certainly your right to criticize. One of the reasons we sent this legislation out to everybody ahead of time was so that, if you had criticisms, you would feel free to make them. I do not kill the messenger around here—not always.

You concluded by saying that, "if we as an industry do not get involved in the Senate,"—I guess presumably to fight the bill—"three years from now this FIA expo might well be held outside the United States."

Well, I would wager that Congress will adopt strong reform legislation, and that 3 years from now, instead of the expo being held outside of the United States, the futures industry, including retail brokerage firms, will be stronger than ever, a great deal more credible, and that the expo that year in Chicago will draw its biggest crowd ever.

Do you want to make a bet on that?

Mr. MAHLMANN. Second the motion.

The CHAIRMAN. Does anybody want to add anything on this?

Mr. Melamed.

Mr. MELAMED. I have no desire to bet against the Senator. However, I must tell you that I watched the Euro-bond market that was created in the United States, through the genius of the private sector, leave the United States because of rules that were passed by the Congress at that time. The Euro-bond no longer is a viable instrument of trade in the United States, but is traded worldwide,

primarily out of London, and gives that city a great deal of economic activity. This is an example of a market we invented and had here sometime back.

The possibility of that kind of thing happening is not an illusion.

The CHAIRMAN. I understand. Mr. Melamed, I hold you in high regard and I have paid a great deal of attention to virtually everything you have written since I have been in the Senate on these issues. I have read them all, all that I have seen. You certainly are one who has done a great deal of innovation in these markets.

I emphasize what I said this morning. I want these commodity markets to remain in the United States. I think they are a unique part of our mercantile history. I want very much for us to have the room to innovate as markets change and as technology changes. I do not want to see one more thing go to Japan, Singapore, Europe, or anywhere else that is so uniquely and importantly American.

But I also do not want to see these markets whither because of lack of credibility and lack of confidence from the American people. I do not expect that you or Mr. Mahlmann, Mr. Guttman or Mr. Fink, want to see that either.

We will try to pass legislation to make sure that confidence is justifiably maintained. But you also will have to be willing to innovate, and use the technology that has made these markets strong. I think that we can do that.

With that, I would yield to Senator Boschwitz.

Mr. MELAMED. Senator, thank you. And I might say that in terms of the philosophy of what you said about dual trading, I certainly have no disagreement with you.

Senator BOSCHWITZ. Mr. Mahlmann, did you want to—

Mr. MAHLMANN. I just wanted to explain to the chairman of why I seconded the motion. Because I am very confident—or hopeful first and confident second—that on the few amendments which the Senator talked about that may occur between now and the final bill, that we can come to a resolution which encompasses the goal of this committee, and which is the goal of our exchanges, that we have fair, honest markets with integrity, and that we do keep them here.

And I am confident in the dialog that this can be done. And that is why I seconded the motion.

Senator BOSCHWITZ. Let me pursue a couple of avenues of questioning if I may, the first about dual trading.

My father for many years was a, you can call him, customers man. Maybe now they would call him a registered representative and stockbroker. He used to have customers, and he would trade stocks for them when they called, or he would drum up a little business by calling them. And, of course, he also had his own stocks and bonds.

When you talk about dual trading, Mr. Melamed, is that what you mean?

Mr. MELAMED. Yes.

Senator BOSCHWITZ. So in a sense, my father was a dual trader in that case if he had stocks for his own account and, very often I suppose, he bought the same stocks that he advised his customers to buy.

Mr. MELAMED. He was exactly that. He was a dual trader.

Senator BOSCHWITZ. And that happens, as you point out, in every element of the marketplace.

Mr. MELAMED. Virtually every element. There are probably some exclusions, but it is all over the world. It is not just in the United States.

Senator BOSCHWITZ. I used to buy plywood, a great deal of plywood and lumber. And some of the people, some of these lumber jockeys, that we used to deal with would buy for their own account and hope the market went up perhaps using—well, eventually we had a futures market. But I would buy from them. And they, too, then would constitute a dual trader I suppose?

Mr. MELAMED. I suspect so.

Senator BOSCHWITZ. I must tell you, if I think back on those days, I have not considered them from the standpoint of that term of dual trader. So everybody in our trade understood that people were buying and selling. And they used to buy these cords of lumber and then send them by way of the Southwest so they would take weeks and weeks waiting for the market to go up.

I suppose that too constitutes dual trading. Is that correct?

Mr. MELAMED. That is correct.

Senator BOSCHWITZ. And what a dual trade is is that somebody is trading for his own account on the floor and trading for others as well?

Mr. MELAMED. That is correct.

Senator BOSCHWITZ. And the difficulties that have arisen with the indictments and so forth, there was not an involvement of dual trading?

Mr. MELAMED. Well, from what we can see, it was not to a very large extent. Now, we are not privileged to see all the information held by the U.S. attorney. But our understanding is that most of the wrongdoings were not as a result of dual trading. And unless we are wrong, that is the impression we have.

Senator BOSCHWITZ. I gather from the statute that dual trading is not done away with. Is that right? I gather from the bill that is before us that dual trading is not done away with, though it is within the jurisdiction or within the purview of the CFTC to do away with it. That you now are entitled to do it and you will now be subjected to a burden of proof, and that may indeed do away with it.

And I suppose that is what you object to?

Mr. MELAMED. Well, to the extent that the bill is written as Mr. Fink describes, the burden of proof is perhaps on the wrong side. Philosophically, I do not have an objection to asking us to lift the standard to a point of satisfaction such that we can ensure there are no violations as a result of dual trading, or that those violations that ought to be detected can be detected.

Philosophically we do not have a problem with creating a standard. The question is what standard? How would it be monitored? Those are the issues where we disagree.

Senator BOSCHWITZ. I gather that my friend from the Minneapolis Grain Exchange will later say that their exchange will be very substantially impacted, as Mr. Guttman has suggested. His exchange is smaller than yours. In the event that dual trading is not allowed in that small exchange.

Is that correct, Mr. Guttman?

Mr. GUTTMAN. That is correct, Senator.

Senator BOSCHWITZ. Let me also ask a little bit about the open outcry. Senator Lugar and I spoke about that during the lunch hour. We were interested in the argument that you make, that the open outcry is faster than the computer.

I tried to structure in my own mind how the trade takes place, thinking more of the New York Stock Exchange, where I have been many times because my dad worked right across the street. But somebody calls in and places an order to a broker, and a broker calls the floor people, or a broker sometimes calls his own people who in turn call the floor people. The floor guy is standing at one of the phones will signal somebody out at a horseshoe, or the pit in this case, and the transaction will occur. And that would be slowed.

Is that approximately the way a transaction occurs? Why is the open outcry faster recording the transaction at each step of the way?

Mr. MAHLMANN. Senator, I would like to answer that. And I would like to use a primary government dealer that is bidding the U.S. Government at auction time for its debt. And the dealer is in contact, for instance, with the phone man of his own company on the Board of Trading floor. He buys, let us say, \$100,000 worth of debt from the government or 100 contracts representing \$10 million worth of debt. He tells his phone clerk to sell 100 contracts in the futures pit on the phone. That futures clerk at the desk flashes into the trading pit to sell contracts—

Senator BOSCHWITZ. What is a flash? A hand signal?

Mr. MAHLMANN. A hand signal. A broker receives that hand signal that his customer, meaning that broker which is in turn a primary government dealer also, wants to sell 100 government contracts. He executes that 100 contracts, reports it back to that phone clerk of the primary government dealer, who in turn reports it is back to the guy that is participating in the auction.

A time and motion study that we have taken at the Board of Trade narrows that whole sequence of events down to 8 seconds, the giving of the order to the floor clerk to the pit to the execution and back.

Now, within the audit trail requirement, which exchanges are to meet, in order on one side to also preserve dual trading, are four separate time stamping requirements that have to occur independently, meaning not by the party that is making the trade, nor by the party that is sending the order.

Time stamp No. 1 would be required on receipt of the order on the floor; time stamp No. 2, receipt of the order by the broker in the pit; time stamp No. 3, execution of the order in the pit; time stamp No. 4, the order returning back to the desk.

All of these time stamps have to occur independently of the party participating either in the trade or in the receipt of the order. That independence requirement is an unattainable audit trail requirement, I submit to you.

Senator BOSCHWITZ. What is done presently? I gather as you go down to the exchange you see the trader with the card, and he marks it down, and then he goes and has it stamped. You now

have something like a time clock around the pits I gather. I am not sure if that is yours or——

Mr. MELAMED. It is correct. Presently, the order is submitted by telephone to the flash clerk who writes it down. He automatically time stamps the order at that point. Then he flashes it. And then when it is flashed back to him as having been completed, he again time records it to establish when it was executed and received back. So you have, in fact, the two critical times—the in and out in the time sequence.

Senator CONRAD [presiding]. Senator if we might follow the lights. Otherwise, we are going to——

Senator BOSCHWITZ. Oh, I am sorry. I did not realize the lights were on.

Before I conclude, if I may, what is presently done and what will this bill require be done beyond what is presently done? Do I gather from Mr. Mahlmann's response that now the receiving clerk at the phone, he records it in and out? But it is also recorded in and out on the floor, is it not?

Mr. MAHLMANN. Senator, the time stamp is being prepared today. There is a recordation of the order coming in. There is a time stamp of the order going out. There is a time assignment within the pit of when the trade is made.

The concern is the word "independence," meaning independent of the party making the trade or independent of the party sending or receiving the order. That is the concern.

Senator BOSCHWITZ. Thank you, Mr. Chairman. I am sorry I did not see the light.

Senator CONRAD. Senator Gorton.

Senator GORTON. The two gentlemen that were here this morning, what I would like to do is give each of you, if you wish, an opportunity to persuade me why it is incorrect to take the position that we should simply abolish the CFTC and transfer its functions and budget to the SEC and have one regulatory body.

Mr. MAHLMANN. Senator, I will start us off.

The SEC and the CFTC regulate totally different products and totally different functions. The SEC regulates a capital formation environment.

The CFTC regulates a risk transfer environment. Futures contracts are a totally price discovery and risk transfer instrument that are being substituted for the actual cash position for an interim period of time. They are not like stocks. They are not like bonds. They do not raise equity, as the other part of the world does.

And we strongly believe that markets, as they have been under this committee's jurisdiction and under the House Agriculture Committee's jurisdiction, should be regulated by function.

Mr. MELAMED. Senator Gorton, the longer I am here, the more I question myself about these issues. I must say that I think implicit in your question is the other question of whether the CFTC has done as good a job as say the SEC would do on some of these issues. I think that's what you really are asking.

And I must say to you that I think the CFTC is getting a bad rap. Because much that the futures industry has, it has created in response to CFTC demands that presently do not exist in the SEC environment. The audit trail we have, for instance, is a very fine

example of this. The futures markets can reconstruct by the next morning the entire trading day of the day before; for example, who traded with whom, how much, within a very small fraction of when, and the money flows between those parties. This information is reconstructed for us to submit and to give to the world the complete record.

Now, I daresay that nowhere but in the futures industry exists an audit trail to the level of sophistication that we have created. And, it is to the credit of the CFTC that we have achieved it. That is only one example, and we could talk about others.

I clearly believe that the CFTC has done a fairly good job in pushing us into directions which other agencies have simply not yet taken.

Senator GORTON. You did get half of my question. The other half of the question is whether or not, in spite of this difference of functions, the dollars that are involved in those functions are very readily transferable? The other half of the question is that if you have two different regulatory agencies, they are going to espouse two different philosophies, even if they are both quite efficient.

And the opportunity for making money legitimately or illegitimately, and the inevitable gaps between those two regulatory philosophies seem to me to be impossible to cover even if both agencies are efficient and effective. They are simply going to take a different approach.

Mr. MELAMED. Clearly there are philosophical differences. I must tell you, however, that the experts at the SEC, certainly at the CFTC, as well as those in the industry, have recognized that the functional differences between these two markets deserve separate regulators, and that separate regulators have a beneficial effect because there is a resulting competitive quality serving the marketplace.

I must say that I recall SEC Commissioner Fleischman's remarks with respect to that. He wholly supported the idea of a separation between these two agencies. I recall that Federal Reserve Chairman Greenspan did not feel the need to combine the two agencies. I bow to that kind of expertise, as well as the expertise within the industry.

Senator GORTON. Well said. Do either of the others wish to comment?

Mr. GUTTMAN. Well, Senator, just to follow up, our business is a business of specialized products, innovation and the creation of new instruments, economic research, to come up with various different products, needs the attention of a regulator that is well versed in the entire avenues of our business.

We have different margin systems. Our margin system is same-day settlement, overnight settlements. The SEC is a 7-day settlement mechanisms, which is completely different than that of our industry. Our 1-day settlement maintains the flow and integrity of the trading process above and beyond what other industries are held to.

There are many different exchanges in the United States, futures exchanges, that need the attention of a regulator for each particular exchange to make sure that the coordination amongst

themselves vis-a-vis the CEA Act to maintain the highest of integrity.

As you did indicate, yes, it is the same dollar that flows. But every industry in the United States is driven by the dollar. That being the case, we are distinct, we are separate. Over the last few years, we have experienced explosive growth and rapid growth in the industry. And along with our growth comes certain amount of growing pains.

I am very confident that the CFTC, given the additional budgetary allotments that this Congress is willing to do, will do a very effective job, as the SEC is renowned for. And 3 years from now, hopefully, we will not have to sit here under these particular conditions. But if we do, I think you will all be pleasantly surprised about the job the CFTC will come in with.

Mr. FINK. Senator, the futures markets have a number of unique characteristics, characteristics that are not shared necessarily by those markets that are under the supervision of the Security and Exchange Commission. They are conceptually different instruments from those that are watched by the SEC. Their products are not homogeneous in the way that stocks tend to be homogeneous. The methods of trading are different from the way stocks are traded. And their method of settlement are different from the way securities tend to be settled.

In addition, they have a whole, unique array and constellation of factors such as internationalization, the effects of technology in their trading methods that call for an independent and special agency to direct its exclusive attention to the problems and issues at stake in the industry.

I guess the bottom line is that if there is something wrong with the CFTC that makes Congress dissatisfied, that we ought to try to fix it, but not throw it away.

Senator GORTON. Thank you, Mr. Chairman.

Senator CONRAD. If I might just ask a series of questions here. I would like to make sure that I am getting the message that you are sending correctly on some of the high-profile issues that are before us.

First of all, I think everybody seems to be in agreement that audit trail is the critical thing we need to focus on. That is what needs to be fixed, that is the problem. The message I am hearing from you is that do not mandate something that we do not know for sure we can produce in terms of a 3-year timetable. That would be the first message I am getting.

The second message I am getting is on open outcry, that to require that we move to something other than open outcry would have a serious negative effect on the competitiveness of our markets, the efficiency of our markets, and that the way to solve the problems that we have are through the audit trail.

A third thing I am hearing is dual trading, that that really is not the problem. There is certainly room for abuse there, but it is also, what I hear you saying, that that has not been the focus of the problem and that in fact with a strong audit trail it will be easy to pick up those who would abuse dual trading. That would be the third message I hear.

The fourth message I hear is the small exchanges have a very difficult problem if we start doing something on dual trading, and also they have a serious economic problem with coming up with an electronic method to improve audit trails since, as I understand it, you all are investing \$5 million in Chicago. That is the entire budget of the Minneapolis Exchange. That would be the fourth issue.

The fifth issue would be fees. What I have heard, if I am hearing correctly, is that the fees are very unclear. It leaves it pretty wide open for CFTC determination on what we would do with fees.

Could I just get a reaction. Am I hearing correctly the major messages that you are sending?

Mr. MAHLMANN. Yes, sir, you are.

Senator CONRAD. Would you alter any of those that I have outlined in terms of my understanding of your positions on those issues?

Mr. MAHLMANN. Senator, I think you heard them loud and clear. And I could not enumerate them any better than you did.

Mr. MELAMED. I would concur with that.

Senator CONRAD. And so it seems to leave me with the conclusion everybody would focus on audit trail. That is really the critical thing that we accomplish here. How we do that is subject to discussion as we go along so we do not throw the baby out with the bathwater.

Well, let me then go back to an issue that I raised this morning with the Chairman of the CFTC. Because I think you all deserve a chance to make clear your position on this matter.

I asked this morning on the 46 people who had been indicted, whether or not any of those were still trading. I was informed by the Chairperson that to her knowledge some 17 were still trading, 11 were trading for accounts other than their own. That was my understanding of her testimony. And I went through it with her several times. That was my understanding of what she was saying. Is that correct?

Mr. MELAMED. Senator Conrad, I would like to respond since I was sitting in the room at the time that interchange occurred. I have checked our records and would like to make several things clear for the record.

At the CME there were 24 indictments out of the 2,700 members we have. Six of those 24 pleaded guilty to one thing or another. Those traders were automatically removed from all trading activity by virtue of the plea of guilty.

I had conversations with the Chairman of the CFTC, the chairman of the Chicago Board of Trade, with independent legal counsel of note, and with our outside counsel, Mr. Salzman, to determine what we should do in such a situation. We recognized, as you did, the sensitivity of this situation; that our decision would send certain messages. We asked what we should do; what can we do; what does the law allow us to do?

And it was determined that by virtue of the constitutional precepts in this country, we could not do anything under our rules or under CFTC rules that would violate the constitutional rights of these people who, while indicted, are still innocent until they have been proven guilty.

So what we agreed to do, was to advise all of these other 18 members who we are asking to please remove themselves from order-filling for customers. That we could understand them trading for their own accounts, because they have not been proven guilty of anything; but that we are asking for the sake of the system, for the sake of good sensibility, that they not fill any customer business.

Now, of those 18, all but 3 agreed. And only three are presently filling orders. In those cases, we have instituted the following: First of all, those three are filling orders for firms who are conscious of it and have agreed that they do not mind. Secondly, we monitor their activity on a daily basis in order to make certain beyond any doubt about what exactly they are doing on the floor since they have not volunteered to give up their business.

Now, those are the clear facts of the situation for the Chicago Mercantile Exchange.

Senator CONRAD. Mr. Mahlmann, if it is all right with my colleagues, we will give him a chance to answer this.

Mr. MAHLMANN. Senator, we had 22 indictes on the Chicago Board of Trade. I believe four of them—I do not have the exact figure with me. I believe four of them have plead guilty. By virtue of the pleading guilty, they have been barred from the exchange. The remaining 18 under the preamble you are innocent until proven guilty, do have the right to access the trading floor. I think approximately 10 have exercised that right.

We have requested any 1 of the 18 not to exercise or to execute public customer orders. All of them have acceded to that request. And we do periodically check that they do not. But it was done at the request at the exchange, not by law, or not by regulation of the exchange. Because the individual is presumed innocent until proven guilty.

Senator CONRAD. I have exceeded my time.

Senator Fowler.

Senator FOWLER. Thank you, Senator Conrad.

Going back, Mr. Mahlmann, to the four or five points that Senator Conrad asked you and all the panel about, I think I am paraphrasing—I will let him speak for himself, but I was trying to listen to this. And I think his first point was that the concern in the legislation, be it the House or the Senate, that we do mandate what you technologically cannot produce within the timeframe. And you agreed that that was a concern. That was your message.

Let me ask you specifically. Under the Senate proposal, can you do it? And this is for the whole panel. Do you see the language in the current bill as a performance standard or a design standard?

Mr. MAHLMANN. Senator, within the audit trail requirements of the bill are some sections that if they remain as is without amendments, that would lead to a computerized market unless a couple of words are taken out. And seeing that Senator Leahy in his remarks said we are not here to abolish the auction style market, the words that present the biggest problem to us in the audit trail are, number one the independence requirement, somebody independently recording the trade, and number two, the sequencing requirements for a total exchange.

And I will use as an example, last Sunday night we had about 700 bond traders in the bond pit at the Board of Trade. They could have potentially all done a trade at the same second, meaning 350 trade with 350, and it would have accomplished 550 trades. There is no computer system out there at this time that could have sequenced those 350 trades at the same second. So that is a major problem within the bill.

The bill then has requirements that it be done within 3 years. What we would strongly support, that there be a self-executing extension within the bill. If it cannot be done, then it should be based on a GAO and a CFTC study that it cannot be done. And then that deadline, if both of those agencies concur, then that deadline be expanded, for technological reasons the audit trail standard cannot be met.

All of this rhetoric does not take anything away from the exchanges having full commitment to try and meet the standard in the time.

Mr. MELAMED. Senator Fowler.

Senator FOWLER. Yes.

Mr. MELAMED. If I could just state in a brief fashion that the way the bill is presently working, it mandates standards that are technologically not feasible. And, if we don't meet those standards, we will be fined \$500,000 per day. I assure you we do not have that kind of money, and that we cannot meet the standard. Consequently, we cannot live with the bill as it is written today.

Now, it can be adjusted. And I believe it will be. And I believe there are reasonable standards that can be achieved. But the sequencing and the independent verification issue is one that we do not have the technological means to attain at the present time.

Senator FOWLER. You are saying—let us be clear—that the technology is not there? It is not the result of doing this that disturbs you?

Mr. MELAMED. Well, that is right. The technology—

Senator FOWLER. But that you simply cannot in the time allotted meet the standards of the bill because the technology that would track this instantaneous transactions in sequence is not now manufactured?

Mr. MELAMED. That is one part of it.

Senator FOWLER. What is the other?

Mr. MELAMED. The second part of it is that in the open outcry system, when one clerk gives a broker an order to sell 100, and the broker sells to 5 or 10 different individuals a portion of the order, he cannot sequence it to the verifiability required. It is just simply not humanly possible to be sure he will not make a mistake.

And if he does make a mistake, he will be violating these rules and will have committed a criminal offense. We cannot place that kind of burden on an individual. He sold to 10 or 15 different people a piece of that order. He is going to write it all down. But I do not know if it will all be in the exact sequence he did it. And that makes it a very difficult standard for us to meet.

Senator FOWLER. I do not quite know how to ask this question. Did the GAO in their investigation and report to us address this issue?

Mr. MAHLMANN. Senator, if I may take the liberty, Mr. Fogel of the GAO—and I think this is maybe more in a press report, but I think it was also stated before Congress—stated that we should look for more precise audit trails I think was his statement. And he compared it at the time rather than look to the ban of dual trading, but he did ask for more precise audit trails. I do not know that he came up with the phrases of the independent recordation of a trade or by the sequential for a whole exchange.

Senator FOWLER. Whose time am I taking?

Senator CONRAD. It is the committee's time. -

Senator FOWLER. I do not mind that.

Senator CONRAD. If we can wrap it up.

Senator BOSCHWITZ. Why does he not finish his thoughts. I would have more questions for this panel.

Senator FOWLER. I beg the committee's indulgence and the panel for just a moment. I was just handed a letter by the staff director from the Assistant Comptroller General of the GAO. He said, and I quote: "We testified and reported that independent, precise, and complete timing, however achieved, should reduce the opportunity to commit certain floor trading abuses and to increase the probability that those committing these abuses will be apprehended."

My question—and I ask forgiveness of the panel if this has been discussed before—is how we make sure that we are all trying to reach the same goal, but we know what is achievable within a certain timeframe. And then how we know—we the overseers as well as the exchanges—can know with confidence that the precision that we are trying to regulate under the law is achieved.

Is that a matter of pertinency? And is that also a matter of concern under either version of this regulation?

Mr. GUTTMAN. May I, Senator? As the GAO report indicated, the catch words here are independent, complete, and precise. Not to beat our own chest, but New York Merc has been found by the GAO to have the qualifications of independence. We do not know what "complete" and "precise" actually entail.

The reason we went off on this hand-held technology endeavor is hand-held technology would tie in beautifully as a front end to the rest of the trade matching system which impacts the entire audit trail. That does not mean that we were lax in seeking other alternatives to comply with independent, complete, precise.

We do not know exactly what those alternatives are. They could technically be unalterable trading cards, they could be an indelible ink. There are a few things that we could look at which might have anything to do with hand-held technology. Yes, hand-held technology is something we should look for because it would be the front-end of an entire series of interactive computer software that goes right through the chain.

But we cannot assure you that within 3 years that entire interaction between the hand-held and the needs and necessities for the floor community to key punch into this unit will filter through and not put the entire audit trail into the computers driving the audit trail through the system at risk if this front end just does not meet the speed requirement. We are not shying away from independent, complete, and precise. We just do not know how to achieve that.

We will look to work with Congress and the CFTC and the GAO to endeavor to accomplish it.

So I do not want any mistaken assumptions that we will in the next 3 years just not look at anything else that might fulfill the requirements of that effective audit trail that this committee and Congress wishes us to achieve.

Senator CONRAD. Senator Boschwitz—oh, do you have an answer as well?

Mr. FINK. I just have a brief additional thought.

Senator, when we asked you for leniency on this 3-year timetable, it is not that we are asking you to just sort of openly trust us. Senator Kerrey referred earlier in the day to the whole notion of accountability. We want to be held accountable.

And I think the suggestion of the chairman of the Board of Trade that a series of accountability systems be set up such that the CFTC and the GAO can routinely and regularly check on our progress that matches both our ability to meet the standards as well as our ability to keep up with the technology, and when we fail those tests, to be punished as we ought to be punished, is the way that we want to go.

That I think is the way to achieve the best results, both in terms of the meeting of the standards, as well as making the maximum use of whatever technology emerges during this whole process.

Senator FOWLER. Well, that is helpful. And I thank the panel. I have some other questions, but I will be glad to—no, no, I will wait.

Senator BOSCHWITZ. Well, Senator Gorton has said if I am going to ask a bunch more questions, you will not wait for the next panel. So I do not want to dissuade any of my colleagues. But I think that we are pursuing the right course of questions.

Let me pursue it also from the standpoint of cost, and also from the standpoint of how other types of similar type transactions are regulated if there are similar transactions. Are there other types of transactions in the trade? Because I think the type of transaction I used to make would not make much of a comparison with these transactions. But are there other types of similar transactions that are regulated in different ways now in the United States? Or are there no other similar type of transactions to these futures transactions, they stand by themselves?

Mr. MAHLMANN. Senator, I would make one comment. In no financial service within the United States is an audit trail equal to the one that was established through the legislation of this committee in 1986 and has been developed since then.

Most evident in the testimony that Commissioner Hineman was able to give subsequent to the October market crash where he, within 4 weeks of the October 1987 crash, was able to tell this panel who did what with whom at what time and in what amount.

That was not available from any other industry. And it is the credit of this committee that made it happen in 1986, and it was developed over that time period.

Senator BOSCHWITZ. I presume that not only are you concerned about whether or not the technology can be developed to conform with this bill within a 3-year period, but you must also be concerned with the cost.

I wonder if some of you would comment what the projected cost is. I presume it is a technology we do not know. It is hard to know what the cost is. But have you made any projections on what you anticipate the cost to be and what that will do to your ability to compete?

Mr. MELAMED. Senator, I would like to respond, and perhaps in a broader sense. We have already indicated that the CME and CBOT are willing to spend at least the \$5 million combined to codevelop the hand-held AUDIT system. However, there is a different cost factor that is implicit in all of this that has not been discussed. And I would like to raise its specter if I could.

And that is the cost factor to the industry that some of the provisions of this bill would either inadvertently or advertently place on this system to make it inoperable. I speak of such things as, for instance, the liability to a firm for what its broker, who is an independent contractor, does.

That is a cost factor, Senator Boschwitz, that has not been discussed. But I would daresay that if we proceed with that kind of liability for a broker who is an independent contractor hired by a member firm—say Merrill Lynch—Merrill Lynch would then be liable for the actions of the independent contractor when he violates a rule. This would literally change the face of our system to an extent that I do not know what the fallout would be. And I am not even speaking about the additional element of treble damages to that member firm in the event that the broker does something in some fashion negligent.

I must say when a member firm sends an order to our floor, he uses maybe 10, 20, 30, 50, sometimes 100 different brokers all at the same time. There is no way the firm can follow their footsteps and know what they are doing.

When they are his employees, we grant you the firm must be liable for employees. But when they are independent contractors, it is quite difficult to assume that kind of liability. And it is that kind of cost factor beyond the actual hard, cold cash that you are bringing to the table that we worry about.

Senator BOSCHWITZ. Well, as you outlined you answered the question from a different part of the bill, a part of the bill which did not trouble me as much. But it seemed to me that if I called my broker, and my broker used a floor trader, some kind of agency relationship has to exist there. I do not know much about the law of agency, but there is no liability in that relationship, or there should be no liability in that relationship.

Mr. MELAMED. Well, he is liable for execution of the order. However, if the customer ultimately sues the firm for some wrongdoing that the broker committed in the process of executing that order, that is the liability that we worry about. It ought not go to the firm from the independent contractor.

Senator BOSCHWITZ. It would just be to the broker.

Mr. MELAMED. To the broker.

Senator BOSCHWITZ. But the customer has no relationship to the broker.

Mr. MELAMED. But certainly that relationship exists.

Senator BOSCHWITZ. It does?

Mr. MELAMED. Yes.

Senator BOSCHWITZ. They have legal standing to pursue those?

Mr. MELAMED. Of course. In fact, each exchange has an arbitration forum which provides the means for the customer to achieve a result from that grievance, as well as the court process.

Senator FOWLER. Will the Senator yield on that?

Senator BOSCHWITZ. Surely.

Senator FOWLER. Just explain to us for the record, how was that relationship legally established before we had the audit trail?

Mr. MELAMED. Well, every broker who——

Senator FOWLER. How did a customer obtain his facts in order to pursue a grievance?

Mr. MELAMED. A customer would present his grievance to the firm. The firm knows which broker fills the order and immediately helps the customer in terms of determining whatever wrongdoing occurred.

Senator FOWLER. What court documentation of his grievance was he able to present?

Senator BOSCHWITZ. The customer, the guy who initiated the trade, the farmer, or whomever.

Mr. MELAMED. Well, the order and the time of sale is there. Even before audit trail, that was there.

Senator FOWLER. Right, and what else? Anything else that he would present?

Mr. MELAMED. Well, the actual rules of the exchange are known to the world, the rules of the CFTC, and contractual and agency law are also applicable.

Senator BOSCHWITZ. Is there much problem with this? Does this happen often?

Mr. MELAMED. It is presently not the case. The present liability runs only to the agents of the firm themselves, and that is how it should be. But this bill would change that requirement. It would change the situation to the extent that it would make it very very difficult for our member firms to do business.

Senator BOSCHWITZ. This kind of thing, I am told, does not come up very frequently, and that there are only two cases.

Mr. MELAMED. I assure you there will be more cases if the lawyers are listening.

Senator BOSCHWITZ. Well, I must tell you, I looked at this bill, as I look at most bills, and wonder who is going to profit and I gather that the lawyers will do well under this legislation. I also gather that a futures commission merchant does not, or those firms on the floor do not really have access to CFTC records of discipline, or background checks; is that correct?

Mr. MAHLMANN. To the best of my knowledge, that is public information, Senator.

Senator BOSCHWITZ. It is?

Mr. MELAMED. Yes.

Senator BOSCHWITZ. We began to talk about the cost of establishing this audit trail, and, then, we got away from that and there are other cost elements in the bill you said that had not yet been discussed that you wanted to discuss, and you did. But what about the cost of establishing the audit trail. Is this a concern of yours?

Mr. MELAMED. Of course. \$5 million is no small sum. The smaller exchanges, indeed, cannot afford that kind of money. We have al-

ready indicated that we are willing to share the results of our development with the smaller exchanges. But, clearly, we do not even know to this moment whether \$5 million is enough, and that is not to speak of the other system changes that will occur internally. We are talking about many millions of dollars that will be spent and will continue to be spent as a result of an attempt to meet higher and higher standards, which we are willing to do. But if those standards put us to a point where they impede our business flow, then we will not have the moneys necessary to meet the standards.

Senator BOSCHWITZ. And you feel that this will impede the business flow by it setting up some additional check points, and you simply will not be able to conduct the business as quickly?

Mr. MELAMED. That is correct, Senator.

Senator CONRAD. Senator, if I might? We are now well past the red light. We can continue the go-around, if you don't mind.

Senator BOSCHWITZ. Fine. Fine.

Senator CONRAD. I would like to go back to the question of people continuing to trade for public account who have been indicted.

Does this raise any concern in your minds with assuring public confidence when people who have been indicted are still permitted to trade for public accounts?

Mr. MAHLMANN. Senator, as I indicated, at the Board of Trade, we have requested those brokers—we know there is no rule, and their personal rights are safeguarded. We have requested them not to execute public orders, and they have adhered to that.

Senator CONRAD. On the Mercantile Exchange we have testimony that there are a number who, even though they were requested to refrain, have refused, and, in fact, are trading for accounts other than their own. Does that cause you concern about assuring public confidence?

Mr. MELAMED. Well, it causes us enough concern that we have special requirements for those traders. We monitor them in a special and strict fashion on a daily basis. Clearly we do have concern about the image it projects. But I must say to you that you are abutting a constitutional requirement that we cannot do anything about. So, in effect, we have done everything we can under the law, and we are prepared to do anything else but only so long as it is within the law.

Senator CONRAD. Do you have the right to suspend members?

Mr. MELAMED. Not without a trial. We are proceeding against those indicted members in independent inquiries and in parallel fashion with the Federal Government with the knowledge of the Federal Government. In some of the instances, we may be a good deal quicker in coming to judgment and resolving some of those issues.

Senator CONRAD. It seems unusual to me that if somebody is accused and accused of wrongdoing in the market place that you do not have the potential to suspend that member, that that is not part of the rules of the game when somebody signs up to be a trader. Is there anything—have your attorneys told you that there is a way to provide that you would be able to suspend traders if you altered your rules in some way?

Mr. MELAMED. I can say that, thus far, our attorneys, as well as independent counsel—and there may, of course, be some legal dis-

agreement on this—have advised us that if we had such a provision it would be found illegal.

Senator CONRAD. It would be found unconstitutional?

Mr. MELAMED. That is right.

Senator CONRAD. Have you shared this information with the CFTC?

Mr. MELAMED. We have had this discussion with the CFTC, sure.

Senator CONRAD. I must say, you are giving much better answers than we got this morning from the Chairman of CFTC on this question.

Mr. MELAMED. Thank you.

Senator CONRAD. I do not see any point in pursuing this further. I must say to you that in terms of assuring public confidence, it would seem to me that when somebody is accused and is highly dependent on the public trust, as are the markets, that the right to suspend, until the matter is disposed of, would seem to me to be an important self-regulatory right. I understand the legal questions involved, and I do not know if anything in this legislation is going to solve that, other than to have a tight audit trail so that at least if somebody is abusing the process you discover it quickly.

Does Senator Boschwitz have further questions about that?

Senator BOSCHWITZ. No. I have other questions.

As I think of it, if one of the Members of Congress is indicted, I do not think that, you know, he or she is prevented from—

Senator CONRAD. Well, we have a way of eliminating them from a membership rather quickly.

Senator BOSCHWITZ. Well, here in the Senate I would say to my friend, it took quite a long time, the only instances that I recall.

Senator CONRAD. I think we all recall some instances over in the House where things moved very quickly. In fact, all it took was the disclosure. We never even got through the process.

Senator BOSCHWITZ. Are you returning the questioning to me?

I wanted to ask Mr. Mahlmann. I notice that you said 285,148 contracts were handled on Sunday evening, which is about 380 trades per member, because you said 700 to 800 members and you take 750. Over what period of time was that, Mr. Mahlmann?

Mr. MAHLMANN. 3½ hours, Senator.

Senator BOSCHWITZ. 3½ hours, so that is 210 minutes, and during 210 minutes each traded at two trades per minute, roughly, 285,000. So you conclude that 3½ hours there were almost 300,000 trades that you, perhaps, would have, under those circumstances, run into that computer blockage, computer tie up at least with present technology?

Mr. MAHLMANN. Senator, on the opening there would have been a dramatic compression of many many trades, because it was the first opening of a financial market after the Friday stock market break, over 190 points. Generally, when you have a stock market break, you have a flight to the quality and safety of the U.S. Treasury instrument. So you have dramatically compressed trading periods in which many many trades take place at the same second, and, then, you go back into lulls. Yes, mathematically you can come up with your formula. Whether that is a market reflection is a second question.

Senator BOSCHWITZ. In other words, you say that of these trades, many were compressed into the opening period. I understand that the opening period is customarily quite a compression of trade, if that is the right terminology.

May I ask Mr. Melamed about GLOBEX? In my conversations with some of the other members of this committee, as we talked about the open outcry system, some members wonder, you know, that GLOBEX seems to have surmounted the problems that might exist without the open outcry. Is there substantially less volume in the off-hours? Is that part of the reason that it can be conducted in that way?

Mr. MELAMED. That is correct. There is, first of all, substantially less volume presently. Second of all, the volume that we are talking about is going to be done through the American night. You cannot really continue an open outcry trading session far into the night. We believe that in order for GLOBEX to succeed—it is not going to be launched till the early part of next year—it will depend on that great viable system that exists during our day, during open outcry.

Senator BOSCHWITZ. I also understand that there have been some efforts in other markets to use computer trading, and it has not done well. Am I correct in that understanding?

Mr. MELAMED. You are correct. As a matter of fact, in Singapore, it is the open outcry system, and it is open outcry at London Financial Futures Exchange and at the Matif Exchange in Paris. Now, to the extent that other exchanges have tried to use computer trading alone without the benefit of open outcry, thus far, they have not yet been successful.

Senator BOSCHWITZ. Have there been records of systems that have been tried and that they had to withdraw from the systems?

Mr. MELAMED. Well, the INTEX Exchange in Bermuda, a computerized exchange, tried for something like 12 years, spent a great deal of time and a lot of people's money, and did not get anywhere.

Senator BOSCHWITZ. You spoke earlier, as well, about the Euro-bond experience, that this was a market that we had that we lost. Could you describe—I am not familiar with that, and I apologize for that. Would you describe that experience and, if you can, compare it to some of the problems that might arise if this bill were imposed?

Mr. MELAMED. Well, the Euro-bond, of course, is an interest rate instrument that was developed here in this country because of tax considerations at that time. Later, our tax laws changed, and because the tax laws were much better placed for that market somewhere else than the United States, we lost that market. Then, when we found out and corrected the thing, it was too late.

Senator BOSCHWITZ. Let me ask questions about the competitiveness with other markets. This morning, if you were here, you may have heard me speak with the Chairman of the CFTC about the competitive nature, and you, also, spoke about the inability to get GLOBEX into Japan.

Would you tell me what you think this bill, if enacted in its present form, would do to your competitive standing in markets, and would it allow new markets abroad to arise and why?

Mr. MELAMED. Well, Senator, I am very concerned that any restrictions that slow down or make our markets less efficient will act to the advantage of competitive markets. The evidence is clear. Even in our case with GLOBEX, where we are leading the industry in terms of technology, the rest of the world does not necessarily want to subscribe to that. Now, while it has been accepted in Great Britain and I think in France and Switzerland soon, the Japanese market has not yet accepted it. If the Ministry of Finance (MOF) can prevent GLOBEX from moving forward in Japan, it would be to their advantage to develop their own market. In similar fashion, if we make our markets inefficient, our competitors will certainly take advantage of that with their markets.

Senator CONRAD. Senator Fowler.

Senator BOSCHWITZ. Pardon me. May I complete something, because in Mr. Fink's testimony he says, "Over the years our exchange has lost business to foreign competitors like the London Metal Exchange due to differences in regulatory constraints."

Mr. Fink, I wonder if you could describe that particular sentence a little more fully.

Mr. FINK. I will try, Senator. We have two broad areas of competition with one metals exchange, one is the copper market and the other one is the aluminum market. I will start with the worst first.

Our attempts to start an aluminum market in this country failed miserably. There are probably a whole variety of explanations for that failure. But one of the ones that continues to be pointed out to us by the aluminum trade is that different ways the contracts are settled in London versus the way they are settled here, different requirements concerning the segregation of funds there versus here all make the flow of business move toward the less regulated market in areas that are of concern to the users of the market.

In the case of copper, although none of the regulatory constraints relate directly to this bill, we have had a number of complaints from users of our markets concerning actions that we have taken to protect against any sort of manipulation squeezes, to promote orderly practices in the delivery of the contract. They complain that the London markets do not subject them to this kind of scrutiny or this kind of pressure to take certain kinds of actions, and as a result, we have reason to believe that there has been a shift of business to the London copper market away from New York as well.

Senator BOSCHWITZ. These are self-imposed constraints, then?

Mr. MELAMED. Well, the particular actions are self-imposed, but they are designed to comply with the act.

Mr. GUTTMAN. Senator, may I respond on behalf of NYMEX on that particular question?

Senator BOSCHWITZ. Yes.

Mr. GUTTMAN. We trade energy, crude oil, heating oil, gasoline, and if there is any clear cut competitive threat, it is quite obvious energy represents 20 percent of international commerce on any given date. We have in London an International Petroleum Exchange which has cloned and mimicked our markets. They have taken our rule books and attempted to recreate what we have created here in the United States.

As Mr. Fink indicated, there are no customer segregated funds in the U.K. The CFTC puts the obligation upon us to have customer seg funds. We, as exchanges, do not allow financing of margin positions on behalf of customers. Overseas you are allowed to finance, and they do it very effectively, thereby, they do not have to get involved in making sure that there is enough deposits on hand to fulfill the loop that takes us through the entire settlement process. In Singapore there is a government policy which promotes a 10 percent cap on any income derived from futures or cash trading. That is a government assistance to that industry at the expense of the U.S. exchanges.

Only 3 weeks ago, we in New York received a delegation from the Ministry of International Trade and Industry of Japan who had sent over economists, computer technicians, people from exchanges, puts us in a situation—we cannot say no, not to invite them, and when they do come down, they come with cameras and everything. Basically, the diplomacy and protocol indicates we have to be as courteous as we can. But we know exactly what they are doing with the information. They are going back and recreating what they see on the floor of the exchanges in the United States.

Now, this is not just symptomatic to our industry. It is symptomatic to every industry in the United States, and if we have learned anything over the last few years, and I am sure it is not escaping any members of this committee—how often do we have to repeat the same error, the same mistakes before we are going to learn that we have to do something for our own industries?

Now, in my testimony I indicated we are not seeking any Government subsidies, anything other than the fact to allow us to innovate and regulate within the confines of the CFTC requirements. If you give us that opportunity, with working along with the committees, I am sure we can maintain this profitable industry in the United States which has a very favorable balance of trade impact on the U.S. budget deficit.

Senator CONRAD. Senator Fowler.

Senator FOWLER. Well, let me follow up on that. I do think these are very helpful lines of inquiry.

Again, quoting from the letter of the Assistant Comptroller General, Mr. Richard L. Fogel, of GAO dated yesterday, the 16th of October, he says in one of his final paragraphs, and I quote, "Finally, CFTC should give the exchanges flexibility in deciding how to meet the requirement, but should also establish firm implementation dates."

We ended the last round with Mr. Fink addressing that, and, then, it is also implied in your answer, Mr. Guttman. Are you satisfied from what you have heard this morning from the Chair of the CFTC and your knowledge of the Senate bill that there is sufficient flexibility to meet these audit trail requirements?

Mr. GUTTMAN. Our position, Senator, is that the terms of independent, precise, and complete have to be defined in a manner that takes into consideration the unique trading matching system, the audit trail functions of each exchange. Audit trail is a catch word which is basically followed in a different methodology by different exchanges in the United States. I do not want to get too technical. We might be running our exchange on Tandem computers, the

CME's might be working on IBM's, the trade matching system might be different, but we all fulfill the requirement of the CFTC mandate. The CFTC should be given the responsibility to work with the exchanges. They have in the past. And I can tell you, as I indicated to this committee back in May, when the exchanges ease up or become lax, they come in and kick you on the shins, and it hurts. If they give you the timeframe, and you basically fulfill that timeframe, they compliment on those issues. This is an ongoing relationship between the exchanges and the CFTC.

Senator FOWLER. What I want to see in this, and I am no expert. I have seen enough of our regulatory attempts over my last 13 to 14 years in the Congress, however long it has been, where many times the problem is not the legislation that we adopt, but the enforcement after we adopt it. I mean, arguably, that is the question right now in the Department of Housing and Urban Development, not what the standards are, but why we did not enforce the standards once the standards became the law.

What I do not want to see is us back here 3 or 4 years from now where the agency, whether it be the GAO or the CFTC or the United States Congress, says that this is what we ask you to do, you have done it, there have been some check points, and yet we are still not satisfied. It seems like that would turn the whole process on its head, and, also, be inherently unfair as a regulatory procedure. But I do not quite know how to get at the fact of how you tie in. I mean, you have the GAO on your side in asking for check points on implementation, that is the timing.

I think we need to know from you what could be a better method to ensure the flexibility, as you say, from exchange to exchange since they are different, the requirements are different, that we can tie those two together and achieve the best result, both as regulators and of you doing everything you can to meet the standards of what will be a very tough law, and I elicit those suggestions as to how, before we make our final determination.

The last thing I would like to say, Mr. Chairman, then I will stop, that Senator Boschwitz also raised. I was discussing with the staff before, we have a requirement under the standing rules of the Senate that in all of legislation, we have to have a regulatory impact statement, and I think this question you were discussing with Senator Boschwitz on what this passage time over the next 3 years will do to our American competitiveness in these unique markets is a genuine one and one that ought to be evaluated as to the economic impact of what we could lose as we make the transfer from the accustomed system to the one that we are requiring you to do. We will do our best to see that a full impact statement is done.

Mr. MELAMED. Throughout the testimony I believe our panel has consistently indicated that it is necessary to remember that the impact in terms of our competitiveness must be examined before we institute any legislation that will impede our ability to compete.

Mr. GUTTMAN. We at NYMEX, and I am sure all the exchanges here in the United States, have no problem with tightening in regard to regulatory atmosphere, the reforms, the pieces of the reform that basically go to the heart of the perception that we

have been a little bit lackluster over the few months. We, as an exchange, have already—

Senator FOWLER. You are not lackluster, the perception of lackadaisicalness.

Mr. GUTTMAN. We, as exchanges, already adopted some of the reforms that are already envisioned in this bill basically without having to wait the 270-day implementation decision. We are in the process right now, if we find one of our brokers that might have violated a customer order, we take his dual trading privileges away right now, right here on the spot. We have increased our fining capacity. We banned certain cross trading. We have revamped our disciplinary committee process. These are all items which basically do not go into the heart of our efficiency or increase the cost of doing business. It is necessary. It could be done. We have already done them, as I am sure everyone else will. But any of the items that basically increase the cost of doing business, put us at a competitive disadvantage to our competitors overseas, a study should be made systematically to see what the result would be. We have no problem with that procedure. That is the procedure that will be adopted. We applaud it. We welcome it and will work with the committee to the best of our ability to see it through.

Senator FOWLER. Thank you very much. Thank you, Mr. Chairman.

Senator CONRAD. If I can go back for one moment to this question of those who are indicted. I have talked to legal counsel here, and they indicate that if it was written into the contract that before somebody bought a seat, if it is in the contract, if you are indicted, you have to recuse yourself from trading for other accounts, that there would not be a constitutional problem with that.

I must say to you that if I were in your shoes, I would be very eager to find a way so that if somebody is under indictment for violating the public trust in the marketplace that there is some way of getting those people to have to stand aside with respect to trading for other accounts, and I would urge you to talk to your legal counsel about an idea like that one where it is in the contract, because I think it sends a very bad message out there.

Folks are indicted for violating the public trust, and they are still able to do their business. I understand you are in a very difficult position absent having a contract position like that.

Senator BOSCHWITZ, do you have other questions for this panel?

Senator BOSCHWITZ. I do. But I would say to the chairman that I have almost completed.

Senator CONRAD. What do we mean by almost?

Senator BOSCHWITZ. Pretty close.

But I would say to the chairman that, generally speaking, I agree with him that from a public relations standpoint it does not help. I am not a constitutional lawyer, on the other hand, but it seems to me it would be from a public relations standpoint advantageous not to have those folks associated.

One of the things, Mr. Mahlmann, that you said—and forgive me for asking the question. It, in some degree, shows a lack of intimate knowledge of your business. You said on page 1 of your testimony, "the markets are a national asset. They provide the lubricant," and so forth. "Just ask any primary dealer who participated in

U.S. Treasury auctions before 1977, what was the bid/ask spread for Cash Treasury Bonds before our Treasury Bond futures market started trading. He'll tell you \$300. What about in 1989 when our bond volume soared to nearly 300,000 contracts per day? He'll tell you \$30." ⁶ The difference between the bid and asked, the \$270, inures to the benefit of the Treasury in effect.

Is that correct?

Mr. MAHLMANN. Senator, as I stated in my statement, the \$300 that were 12 years ago as a bid and ask spread, which are now 30, inures to the Treasury, exactly correct, or to the taxpayer in the end.

Senator BOSCHWITZ. In other words, when the Treasury comes to sell their bonds, they get—

Mr. MAHLMANN. \$270 more.

Senator BOSCHWITZ [continuing]. \$270 more? I presume that adds up over the course of a year.

Mr. MAHLMANN. If you extrapolated that over two point some trillion dollars worth of debt, I presume it adds up.

Senator BOSCHWITZ. And it was interesting that you say: "I will flatly state that our markets could not have performed as they did Sunday night if such a standard had been in place" ⁷ because of the great crush of orders apparently, particularly that come at the outset of the session. So that simultaneously the computer technology has not been developed to take those simultaneous orders. Is that what you are driving at?

Mr. MAHLMANN. Well, because of basically two requirements, the independence and sequential requirements within the audit trail.

Senator BOSCHWITZ. You know, we may be making a mistake by assuming that establishing this audit trail, that indeed by the use of computers the audit trail becomes infallible. Again, I am not a computer expert, but I read a good deal about people who seem to be able to thwart the infallibility of the computer.

I will examine that too so that we do not impose on your exchanges great expenses and then have a new type of trail that can somehow be aborted or somehow be assumed upon in a new way that we have not yet anticipated.

My final questions deal with the \$4.6 million a year, if I am correct in that amount, about \$5 million a year that would be assessed on the exchanges in order to make the additional costs of the CFTC self-liquidating, \$5 million or \$6 million a year. Is that about correct?

Mr. MAHLMANN. Senator, I heard this morning that that was the figure. The reading that we arrived at out of the bill is that S. 1729 potentially provides the avenue for the CFTC to fund its whole budget through service charges against the exchanges.

I do not know that that is meant in the bill, but the legal reading that my counsel has given me provides that that could be the interpreted avenue. I do not know that that is the intent.

Senator BOSCHWITZ. I am told by the staff that the intent of the bill is only the increase, not the entire budget. And so it is well

⁶ See p. 80.

⁷ See p. 82.

that we make that part of the record so that the legislative intent is only the increase.

Mr. MAHLMANN. I am sure then the bill will reflect the intent.

Senator CONRAD. Would the Senator just yield on that point?

Senator BOSCHWITZ. Sure.

Senator CONRAD. Because I think you are on to something that is important here. And we ought to flesh out the record.

When we talk about only the increase, are we talking about the increase over the baseline or are we talking about the entire increase? I assume from what I hear here we would be talking about the increase over the baseline, which would be substantially a different number than the entire budgetary increase that is contained in the legislation.

Senator BOSCHWITZ. As I recall the conversation this morning, the CFTC budget over the next 4 years would be \$66 million instead of about \$40 million.

Senator CONRAD. \$41 million to \$66 million, that is correct.

Senator BOSCHWITZ. So \$25 million. So that is about \$6 million in addition each year. The baseline would go up during the cost of the 4 years, is that what you are driving at?

Senator CONRAD. Yes. You know, the point I am making is the problem we run into all the time in the Budget Committee, is when we say they are responsible for the increase, what increase are we talking about? Are we talking about the whole increase, the \$25 million, or are we talking about the increase over the baseline which would be a number that would be more than that?

Senator BOSCHWITZ. What the Senator is saying is that the \$40 million would have increased anyway, as most government expenditures seem to do with a good deal of regularity, and so that it would not be the entire \$26 million, but somewhat less than the \$26 million. So let us say it is \$5 million a year, that is 2 cents a transaction if we are correct that there were 250 million transactions.

Is that too difficult a burden to bear? I presume that a 5,000 bushel wheat contract is a little bit different than many, the platinum or oil contract of Mr. Guttman, or the aluminum contract of Mr. Fink, or copper, which I presume is larger. But is that too much for the industry to bear?

Mr. MAHLMANN. Senator, then we are right back to our transaction tax. Currently, whether in guise or not, in S.1729 it is billed as a service fee. You just equated it back to a transaction tax.

In 1982 the act provided for the authority of the CFTC to charge for certain service they performed and charge those to the exchanges. But when you now equate the 2 cents per contract, we are back at a transaction tax. I submit to you on one side we will be 2 cents more expensive than a competitor outside of the United States.

And I would submit to you a competitive budget, for instance, with the SEC, the SEC transaction tax amounts to about 20 percent of their budget. It happens to be 3/100 percent of the value of the shares that are traded. And that is not very far off from what today the industry pays to the NFA. Eighty percent of the SEC budget is funded from registration of new issues and companies.

And I submit to you that there is not equivalent instrument in the futures industry because the new issues of companies, whether they be bonds or companies themselves, the companies are the beneficiaries that pay the fee.

There is no commensurate instrument in the futures industry. The futures industry is a price discovery/risk transfer system. So it does not have, per se, a direct benefit or beneficiary that could pay these increased fees. And whether it is 2 cents or 3, I still submit to you it would be a transaction tax.

Senator BOSCHWITZ. Well, I understand that is true. No matter what you call it, it would still be a transaction fee. It would be an additional cost. I guess I have thought about the futures market as a politician principally as it affects my farmers. And I guess they pay on a 5,000 bushel contract \$50, a penny a bushel. So that the 2 cents does not appear to be so confiscatory. But I would be happy to continue that discussion at some other time.

That is the termination of my questions, Mr. Chairman. I see that we have a vote that is being called.

Senator CONRAD. We do. And we will stand in recess.

And at this point I thank this panel as well, for your participation. It has been a long afternoon. We very much appreciate the help that you have been to the committee. I think it has been a productive afternoon, hopefully for you as well as for us.

And when we return, we will proceed with panel No. 2.

Senator BOSCHWITZ. What are we going to do about panel Nos. 3, 4, and 5, Mr. Chairman?

Senator CONRAD. Well, I am what is known as the temporary chairman. I am going to leave that in the good offices of the permanent chairman. That will be his problem to wrestle with.

Mr. MAHLMANN. Mr. Chairman, I would just request for the record to submit the full written testimony.

Senator CONRAD. Without objection.

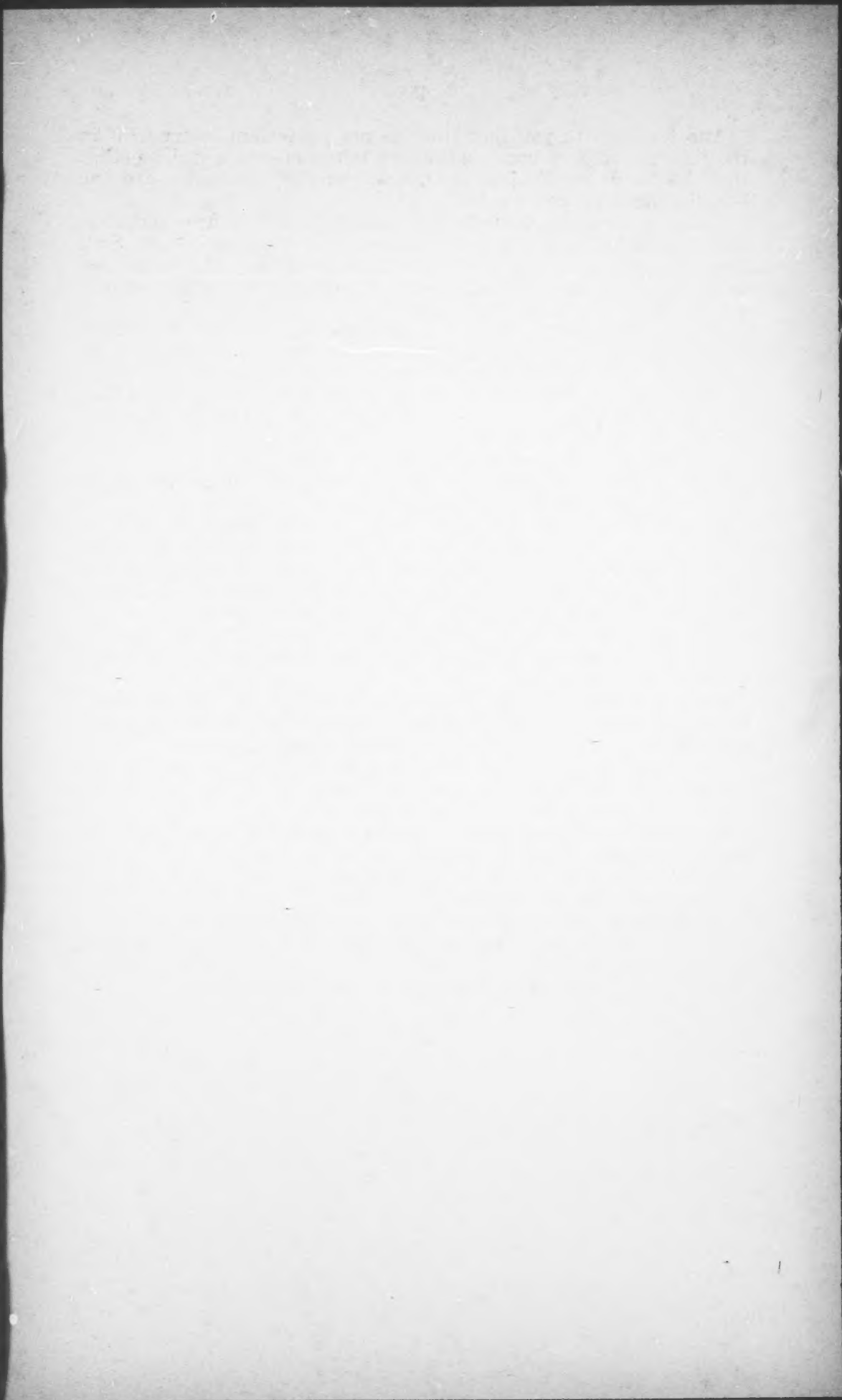
Senator BOSCHWITZ. Submit several copies of that, submit a bunch of copies of that.

Mr. MAHLMANN. I have, Mr. Chairman.

Thank you, Mr. Chairman.

[Whereupon, at 5 p.m., the committee recessed, to reconvene at 8:05 a.m., Wednesday, October 18, 1989, in room SR-332, Russell Senate Office Building.]

[Material submitted for inclusion in the record follows:]



APPENDIX

NATIONAL COTTON COUNCIL OF AMERICA,
Washington, DC, October 16, 1989.

The Honorable PATRICK J. LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, United States Senate,
Washington, DC.

Subject: Reauthorization of the Commodity Futures Trading Commission.

DEAR MR. CHAIRMAN: This is to convey the National Cotton Council's support for reauthorization of the Commodity Futures Trading Commission and to urge the committee not to place unnecessary restrictions on industry practices or the trading of cotton futures or options contracts. The continued efficient functioning of the New York Cotton Exchange No. 2 contract is extremely important to all segments of the U.S. cotton industry. We believe the Commission has generally responded to the industry and provided adequate oversight and safeguards with minimal interference of the New York Cotton Exchange.

Mr. Chairman, although S. 1729, Futures Trading Practices Act of 1989, does not contain provisions concerning insider trading, the cotton industry is sufficiently concerned by the provision recently adopted by the House that we wanted to advise you of the following resolution unanimously adopted by our Board of Directors on September 22, 1989:

In regard to the CFTC reauthorization bills, the Council should seek to (1) clarify the definition of insider trading, (2) remove restrictions on using information gained during trading to hedge or to speculate using such information inside the permissible speculation limits, and (3) prevent the legislation from excluding speculation within the permissible limits using information gained in the course of pursuing business.

The National Cotton Council is the central organization of the cotton industry with members from seven separate industry groups: producers, ginners, warehousemen, seed crushers, merchants, cooperatives and textile manufacturers. Our industry strongly believes any provision which would make it unlawful to use or pass on privately developed market information would seriously inhibit the efficient operation of commodity futures markets. In the case of cotton, the use of the New York Cotton Exchange No. 2 cotton contract is the very heart of our industry's ability to compete in domestic and international markets. Without the ability to effectively hedge, cotton merchants, cooperatives and textile mills would be unable to sell forward—a practice which is extremely important to the U.S. cotton and textile industry. Any restriction of this practice would seriously impair our industry's competitive position and would adversely impact producer income and government program costs. As the committee considers the reauthorization legislation, we urge you to oppose inclusion of any provision which would restrict the market participation of any person or group of people because of their knowledge of the market.

We would also urge careful consideration of the cost implications for the smaller exchanges, such as the New York Cotton Exchange, of overly ambitious audit trails and other compliance provisions. Certainly our industry is supportive of a balanced and realistic compliance and audit program, but we urge recognition of the limited financial resources of various exchanges and how cost would impact their ability to meet the requirements while continuing operations.

Thank you for the opportunity to comment. We would appreciate your assistance in entering these comments in the record of the hearing of October 17, 1989.

Sincerely,

JOHN MAGUIRE,
Vice President—Washington Operations.

UNITED STATES GENERAL ACCOUNTING OFFICE (GAO),
Washington, DC, October 16, 1989.

The Honorable PATRICK J. LEAHY, *Chairman*,
The Honorable RICHARD G. LUGAR, *Ranking Minority Member*,
Committee on Agriculture, Nutrition, and Forestry, United States Senate.

We are responding to your request to comment on those provisions of the committee's Commodity Futures Trading Commission (CFTC) reauthorization bill (S. 1729) that are related to improved trade timing. Those provisions are consistent with our recommendation that CFTC direct the futures exchanges to independently, precisely, and completely time each trade and specify a timeframe for meeting this requirement.¹

We testified and reported that independent, precise, and complete timing, however achieved, should reduce the opportunity to commit certain floor trading abuses and should increase the probability that those committing these abuses will be apprehended. To meet the performance standard, timing must be free from floor participant manipulation. Also, time recording should include the precise time the broker receives each order as well as the precise time that floor participants record as executed each trade. Additionally, times should be sufficiently precise to sequence each floor participant's trades. Finally, CFTC should give the exchanges flexibility in deciding how to meet the requirement but should also establish firm implementation dates.

The Senate bill and our standard are consistent with the trend toward greater automation in the futures industry. We recognize that implementation of the standard contained in the Senate bill may impose additional costs on the futures industry. However, it may also provide numerous benefits in addition to a greatly improved ability to detect and deter trade practice abuses. These include greater public confidence and operational efficiencies, and, potentially, enhancements to the competitiveness of U.S. futures markets.

RICHARD L. FOGEL,
Assistant Comptroller General.

¹ *Futures Markets: Strengthening Trade Practice Oversight* (GAO/GGD-89-120, Sept. 7, 1989) and *Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks* (GAO/IMTEC-89-68, Sept. 7, 1989).

FUTURES TRADING PRACTICES ACT OF 1989— S. 1729

WEDNESDAY, OCTOBER 18, 1989

**U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.**

The committee met, pursuant to notice, at 8:05 a.m., in room SR-332, Russell Senate Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Heflin, Lugar, Boschwitz, and Gorton.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. Good morning. I appreciate everyone coming. Apparently, this hearing generated more interest than we thought. I had suggested that we come back at around 9 or 10 last night and wrap it up, but I understand that this would have created conflicts for some of the witnesses. So we are doing it today.

I invite Mr. Willis Eken, Mr. Jack Frick, and Mr. Harvey Joe Sanner to come on up and join us.

I note for the record that Philip Feigin, the commissioner of the Colorado Division of Securities, State of Colorado, had to go back to Colorado. His prepared statement will be inserted in the record as though read.¹

Mr. Eken, go ahead. We will lead off with you, sir.

STATEMENT OF WILLIS EKEN, PRESIDENT, MINNESOTA FARM- ERS UNION, ST. PAUL, MN, REPRESENTING THE NATIONAL FARMERS UNION

Mr. EKEN. Thank you, Mr. Chairman.

INTRODUCTION

My name is Willis Eken. I'm here representing the National Farmers Union and our 300,000 farm members throughout the United States. I really appreciate the invitation to participate in your hearings on a very important piece of legislation.

¹ See pp. 643-646 for the prepared statement of Philip A. Feigin, chairman of the Enforcement Section of the North American Securities Administrators Association (NASSA) and commissioner of the Colorado Division of Securities.

LETTER

This past summer, with all of the controversy that's been surrounding the futures markets in the United States, our national president, Leland Swenson, wrote you a letter² some time earlier this summer and identified four areas that we thought were important for the Agriculture Committee as an oversight committee to take a look at in dealing with some of the issues that we saw surfacing through these past several months.

One was for more authority to be established within the CFTC, calling for the resources for a stricter enforcement of the law and of the enforcement authority that is within the CFTC, for vigorous prosecution and for meaningful penalties to be imposed on those that were involved in fraudulent action within the futures market, and also for more public involvement in the oversight and operation of the exchanges.

We also had the opportunity to review the GAO report which was, again, authorized or requested, as I understand, by your committee and by yourself. And as we look at S. 1729, we really feel that you and the committee and the sponsors of this bill have attempted to address those general questions that we have raised in terms of concern about the Commodity Futures Trading Commission.

WE CERTAINLY SUPPORT THAT PART OF THE BILL THAT CALLS FOR THE FEES AND A FEE-GENERATING PROCESS TO GENERATE THAT RESOURCE

When we look at the area of establishing the funds and the resources to fund more enforcement activities within the CFTC, we certainly support that part of the bill that calls for the fees and a fee-generating process to generate that resource.

As I listened to the testimony yesterday, I was somewhat appalled at the feeling on the part of some of those within the industry at the kind of burden that supposedly this was going to place upon the system to fund this enforcement. And if I understood correctly, one of Senator Boschwitz' analysis of that cost, he got down to 2 cents per contract. I would suggest as a farmer I'm willing to pay that 2 cents based upon the other costs that I've already paid to have the use of this market. It seemed to be kind of an appalling fact to me to say that this is somehow going to be a burden in terms of being competitive and being able to generate the resources for the Commission. I don't know what kind of costs we put on credibility, but if I can spend 2 cents on a contract and get some credibility back in the marketing structure, Mr. Chairman, I can assure you we're willing to do that.

AUDIT TRAIL

I'm going to come down to the audit trail. The GAO report was very specific in the need for independence in terms of being able to determine the validity of the audit trail and to be able to trace back to the individual traders within the market. We certainly support that and think it's an absolute necessity to do that.

² See p. 464 for the letter of Leland Swenson, president, National Farmers Union, dated August 3, 1989.

Again, I listened to the comments and the testimony yesterday, and this seemed to be another area of real concern in terms of the market being able to function if we put this burden of the independent audit. I would suggest as a farmer, as I've looked at the activities of the market this last summer, you get 46 indictments, 19 of those coming in the soybean pits. I understand that we have 400 traders in the soybean pits. I'm not very comfortable as a farmer to look at the possibility of a contract having 1 in 20 chances of being in the hands of those that have already been identified as potentially doing some things wrong in the market.

Again, I think we need to look at ways to try to enhance that ability to have a good audit trail back through the system. There are real questions about the 3 years in terms of whether or not they can comply with establishing the audit trail. We certainly support whatever judgment of the committee in terms of what that timeframe should be, we certainly think that's a very reasonable request to have.

The CHAIRMAN. You think 3 years is reasonable?

Mr. EKEN. My perception is that 3 years is a long time, but I don't know and understand the intricacies of putting a system in place and certainly support the judgment of the committee in terms of that 3 years as a target time that should be realistic.

SUNSHINE PROVISIONS

When it comes to the sunshine provisions, we certainly think this is an absolute necessary part of any restructuring of the CFTC. I think we had a good example of that yesterday with Senator Eagleton and his comments. I think we need that kind of public interest to provide for openness, if you will, for a self-regulatory structure, a self-regulatory agency.

Conflict of interest, just by the fact that you have a self-regulatory structure, it's absolutely necessary, we think, to have in place a mechanism to try to identify and minimize that conflict of interest appearance.

CONCLUSION

In closing, Mr. Chairman, I would just like to say that we find it very difficult to accept the fact that somehow this kind of direction and oversight is going to cause difficulty for competition in the international market. As I sat and listened yesterday to the comments, especially of the four gentlemen representing parts of the futures market, if you're looking at efficiency, one of the things that troubles me as a farmer is—I was looking at yesterday's paper here. We had 46,000 contracts that were traded yesterday in the soybeans. If our arithmetic is correct, that amounts to 230 million bushels transacted yesterday by contract.

I read somewhere—and I can't remember where—something about every time we raise a bushel of beans that goes into the futures market, it's traded 37 times. I don't know if that's accurate or not, but I think I remember reading something like that. What hit me yesterday is, you know, if we're looking for efficiencies in the marketplace—now, understand the futures market is not necessarily a delivery market. It's a price-discovery system. It actually

doesn't move a bushel of grain from my farm into the market, but it's there as a price-discovery to know what we should get paid, or what it should cost those that need the soybeans in this case. I couldn't help but sit there and think, you know, what is the optimum number of trades we need within the marketplace, within the futures market, to establish the realistic price for me as a farmer. I don't know if anyone has ever looked at that. But if you talk about efficiency, it seems to me that that's a better place to look than to try to grumble about 2 cents a contract in terms of whether or not we've got the funds to have enforcement.

WE SUPPORT THE BILL

Mr. Chairman, in closing, I just wanted to say that we support the bill. We think it's a major effort on your part. We commend you and the other sponsors of the bill for moving forward with it. We need it. As family farmers, we need the protection that you're trying to place into the system with this bill. Our whole price, our whole income mechanism is triggered by the futures market.

With that, Mr. Chairman, I appreciate the opportunity to testify.

[The prepared statement of Mr. Eken and letter, dated August 3, 1989, from Leland Swenson, president, National Farmers Union follow:]

Testimony of Mr. Willis Eken, representing the National Farmers Union, presented to the Senate Agriculture, Nutrition and Forestry Committee.

Thank you Mr. Chairman. My name is Willis Eken, and I serve as president of the Minnesota Farmers Union, member of the board of directors and vice president for international relations of the National Farmers Union. It is on NFU's behalf and its nearly 300,000 farm families that I am testifying today.

I commend you, Senator Lugar, and the cosponsors of the Futures Trading Practices Act of 1989. The recent indictments of 46 commodity traders and the controversy surrounding the July contracts for soybeans heightened the skepticism that farmers and ranchers have about the futures market. These latest revelations exacerbate the distrust that producers have of the futures market being a credible price-setting mechanism. Hundreds of our members have voiced concern over the integrity of the futures exchanges.

Recently NFU's President Leland Swenson sent a letter to the members of Congress concerning the reauthorization of the Commodity Exchange Act (copy attached). He indicated that Congress has an opportunity to alleviate much of the ill will that farmers have for the futures exchanges by making major changes in the Commodity Exchange Act reauthorization. Mr. Chairman, you and the cosponsors have produced a bill that makes those changes.

Specifically, President Swenson asked that there be more openness in the industry's operations, greater authority for the Commodity Futures Trading Commission (CFTC), stricter enforcement of existing laws, vigorous prosecution of those involved in fraud, and farmer and rancher participation in the oversight and operation of the exchanges. In my opinion, S. 1729 accomplishes all of those objectives.

First, this bill assures the financial wherewithal for the CFTC to be an effective agency. This increase in funding and five-year authorization of the CFTC should allow the commission to be more effective.

If the exchanges are to be self-regulatory, then they must pay the cost of oversight of this regulatory process. The implementation of service fees is an effective and fair way to finance the oversight that is needed. Financing the cost of oversight should not be a burden on the taxpayer in this period of budgetary constraint. Those that benefit from the use of the exchanges should be expected to pay for the service that they receive.

The requirement that the exchanges install new audit trails capable of capturing transaction times independently, precisely, and completely, is an important and needed requirement. This is especially important to farmers and ranchers who are using the futures markets on a regular basis as a hedging mechanism.

Farmers and ranchers need to be confident that they are receiving a price that has been fairly negotiated. A September General Accounting Office (GAO) report, "FUTURES MARKETS - Strengthening Trade Practice Oversight," concluded that, "Weaknesses in controls over futures trading provide dishonest floor participants with the opportunity to cheat customers by noncompetitively executing orders and to conceal this cheating by manipulating the recorded price and time of trades." This finding confirms a long-held suspicion of farmers and ranchers.

Requiring an implementation within three years of new audit trails capable of capturing transaction times independently, precisely, and completely, is imperative to the restoration of users' confidence in the futures trading system. Vigorous and

aggressive oversight on the part of the committee is a must if these provisions are to be fulfilled in a timely and responsible manner.

Providing a carrot-and-stick approach to the problem of dual trading may produce the needed changes to ensure that this type of trading does not result in abuses. Giving the exchanges the opportunity to demonstrate that their trade oversight systems can detect and correct abuses places the burden of performance on the exchanges. If the exchanges desire to continue dual-trading types of actions, they must show that they can police those actions.

The expansion of the CFTC's power to force exchanges to improve their trade-practice oversight and disciplinary systems is an important step towards improvement of overall self-regulation by the exchanges. If the exchanges are to be self-regulated, then they must have meaningful and strictly enforced standards.

It is incumbent upon the CFTC to ensure that exchanges are in compliance with the standards. Penalties for noncompliance must be harsh enough to ensure that compliance will be forthcoming. The requirement of the CFTC to assess each exchange on a two-year cycle, coupled with meaningful enforcement options, ensures that the exchanges will faithfully execute their self-regulatory function.

Perhaps the most meaningful section of the Futures Trading Practices Act of 1989 is the "sunshine" provisions section. When NFU's President Swenson wrote to the members of the committee about the reauthorization of the Commodity Exchange Act, he stated that "if producers' confidence is ever to be gained by the exchanges, then producers must have participation in the oversight and operation of the exchanges".

The "sunshine" provisions of the proposed legislation do offer meaningful participation to the public sector. These provisions are needed to expose to the public the interworkings of the exchanges. In the past, decisions too often were made that smacked of collusion at worst and a good-old-boy network at best.

One of the functions of the futures market is that of a price-discovery mechanism that affects the cash price received by producers. Hence, farmers and ranchers that do not participate in the futures market are still profoundly affected by its operation. It is for this reason we advocate that membership on the boards of directors of the various exchanges include producers of the commodities traded on the exchange.

Likewise, it would enhance the integrity of the disciplinary committees of the various exchanges to have producer members. The inclusion of producers on these various committees would do much to alleviate the distrust that producers have of the futures market being a credible price-setting mechanism.

In addition to supporting producer membership on the various exchanges, we advocate the establishment of membership for the general-purpose farm organizations on the CFTC. Farmers are disgusted and frustrated with a futures system over which they have little control and that virtually dictates the price they receive for commodities they produce. Farmers have always been skeptical of the futures markets' benefits for producers. Farmer representation on the CFTC would help to alleviate that skepticism.

The conflict-of-interest provision is a much-needed improvement. This could prevent board members with an apparent conflict from participation in exchange-emergency actions. This review by the boards, of the participants involved in such actions, would alleviate much of the criticism of the decisions of the boards.

This provision, when coupled with the one establishing non-member public directors, becomes a powerful tool to ensure impartiality and fairness in board decisions. Had these mechanisms been in place at the Chicago Board of Trade (CBOT) when the July soybean order was under consideration, producers would have more readily accepted the CBOT's decision.

Other powerful and needed provisions of the proposed legislation are the ones on civil liability and punitive damages. These are the types of provisions needed to restore the confidence of participants in the exchanges. These provisions establish a participants' "bill of rights" by: 1) allowing victims to sue for recovery and punitive damages; 2) making brokerage firms accountable for their brokers; 3) requiring victim notification; 4) requiring the arbitration systems under the National Futures Association and exchanges to provide for punitive damages; 5) and authorizing the CFTC to adopt rules for class action suits under the reparations system.

This set of "participants' rights," and the establishment of new penalties with real teeth in them, send a strong signal to those who would perpetuate fraud in the futures industry. It says that the sponsors of this bill, and I hope the members of this committee, will not stand for criminal activities. Gentlemen, I implore you, do not water down these particular provisions. Let those who are engaged in illegal activities know that they will be caught and that they will be dealt with severely.

The broker-association-disclosure provision and the requirement to establish rules for trading among broker-group members, as well as the requirement for establishing rules for oral orders, will help inhibit abuses.

Providing CFTC the authority to conduct undercover investigations and requiring floor trader registration will help ensure that those involved in wrongdoing will be caught. And, giving the GAO explicit access to data will help to ensure that Congress is fully aware of how business is being conducted at the CFTC and the exchanges. These measures will help to instill public confidence in the futures industry.

The adoption of the proposed legislation and the incorporation of many of the measures adopted by the House will help to improve the futures industry. The study of additional delivery points is an idea that is way overdue. I would hope that Congress takes the necessary oversight to ensure quick implementation of the results of this study.

Perhaps only legal remedies will correct the losses that many soybean producers believed resulted from the CBOT's July soybean order. Those legal actions may benefit only a few of the producers. This bill, however, takes positive action to protect all the producers and ensures that future activities will be open, fair and just.

Recent events have exacerbated the distrust that farmers and ranchers have of the exchanges. This legislation provides meaningful solutions that will build the framework for an atmosphere of trust and confidence in this important industry. Farmers and ranchers have a real need for a price-discovery system. These changes will ensure that there will be a price-discovery mechanism in which farmers and ranchers can place their trust and confidence.



NATIONAL FARMERS UNION

August 3, 1989

The Honorable Patrick J. Leahy
United States Senate
Washington, D.C. 20510

RE: Commodity Exchange Act

Dear Mr. Chairman:

Yesterday's announcement of the indictments of 46 commodity traders and the controversy surrounding the July contracts for soybeans heightens the skepticism that farmers and ranchers have of the futures market. These latest revelations exacerbate the distrust that producers have of the futures market being a credible price-setting mechanism. I have heard from literally hundreds of our members voicing concern over the integrity of the futures exchanges.

Congress has an opportunity to alleviate much of the ill will that farmers have for the futures exchanges by making major changes in the Commodity Exchange Act that is due for reauthorization this year. Sunshine provisions are needed to expose to the public the interworkings of the Commodity Futures Trading Commission and the exchanges. Too often, decisions are made that smack of collusion at worst and a good-old-boy network at best.

The establishment of memberships for the general-purpose farm organizations on the Commodity Futures Trading Commission, the exchanges' governing boards and disciplinary committees would be another measure that would be helpful. In general, farmers are disgusted and frustrated with a futures system that they have little control over and that virtually dictates the price they will receive for commodities produced. Farmers have always been skeptical of the futures markets' benefits for producers, and now producers' confidence has sunk to an all-time low. If producers' confidence is ever to be gained by the exchanges, then producers must have participation in the oversight and operation of the exchanges.

The Commodity Futures Trading Commission's authorities must be strengthened, and the agency must be held accountable by Congress for the oversight of the exchanges. Strict enforcement of existing laws and vigorous prosecution of those caught perpetrating fraud or conspiring to manipulate prices is needed.

Farmers, ranchers and those that participate in the exchanges must be assured that commodity prices are a result of the forces of the marketplace, and that prices have not been manipulated by unscrupulous individuals or corporations.

The House Committee on Agriculture has already made meaningful revisions in the legislation that it has passed, and the Senate Committee on Agriculture, Nutrition and Forestry is preparing for action this fall. The consideration of these suggestions would help enhance the exchanges' image with farmers and ranchers and alleviate much of the suspicion and distrust that producers now harbor.

Thank you for your consideration and time on this matter.

Sincerely,

Leland Swenson
President, National Farmers Union

The CHAIRMAN. Thank you, Mr. Eken. I'm sorry we're going to have to stick to the light system because of the Senate schedule this morning, which includes a joint meeting of the House and the Senate. We will probably have to stop at 10. If there is anyone left, then I will be willing to come back again at 10 tonight. That's the situation we are in. I appreciate the testimony and also could not agree more on the 2 cents. It's a small price to pay for credibility. Mr. Frick.

STATEMENT OF JACK FRICK, CHAIRMAN, FUTURES SUBCOMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION, SCOTT CITY, KS

Mr. FRICK. Thank you, Mr. Chairman.

INTRODUCTION

I am Jack Frick, and I represent the National Cattlemen's Association (NCA) here today. I'm chairman of the Futures Subcommittee of that organization. I also represent them to the Commodity Futures Trading Commission (CFTC) Agriculture Advisory Committee. NCA has been active in the past on reauthorization of the CFTC and worked with the CFTC and exchanges on futures-related issues.

INTEGRITY IN THE MARKETPLACE IS AN ABSOLUTE NECESSITY

Integrity in the marketplace is an absolute necessity if we are going to have a market that our membership and our industry can use for risk management. That's why we're so interested in this particular reauthorization.

TITLE I—AUTHORIZATION OF APPROPRIATIONS

We would like the CFTC to become a permanent agency and with annual oversight hearings. We think that the funds could be used much more efficiently if they had permanent authorization, and they would not have to be preparing for a reauthorization process every 3 years. I think most of those funds could be redirected for surveillance and oversight in the futures market.

The bill as presented does allow increased funds, increased personnel and funding. Increased personnel could be hired by the CFTC. This is central to the mission of the Commodity Futures Trading Commission on what we need for them to look for in the futures. Personnel and funding have been outstripped in the last several years by the tremendous increase in the futures market.

WE BELIEVE THAT THE EXCHANGES SHOULD BE SELF-REGULATED

We believe that the exchanges should be self-regulated, and that the CFTC should draw the guidelines that they want the exchanges to meet, and then the CFTC to check to see whether they are reaching those guidelines. I think the guidelines can be set and exchanges can have a lot more creativity on how they're going to reach those objectives, and they can be much more efficient and determined in that than the CFTC having to dictate exactly how they're going to reach those objectives. So we strongly believe in self-regulation. I think the concept of CFTC as a strong oversight,

and they're going to need the adequate resources and personnel to be able to do that.

AUDIT TRAIL

The audit trail is one area, is the main area that our committee, National Cattlemen, is probably pretty unhappy with. I know we spent a lot of time on the audit trail yesterday, or your committee did, and I think it's a little bit tricky in that the only trades that are stamped on an audit trail is the outside trades that are called in from the country. The trades of floor traders are only stamped for time within a 30-minute time bracket that that trade was made. And if they did not take the other side of the trade from an outside order, that card is not time-stamped.

We maintain that an adequate audit trail cannot be determined with only outside orders time-stamped. When they come in, time-stamped at the desk, time-stamped at the pit when the trade is done, and then when it goes back out. So I think there's a big gap in there, and I think that's a very tricky thing and elusive to get an adequate audit trail established. And we surely want the 1-minute guarantee of recreating the audit trail. The fact is, with today's electronics and computerization, it's hard for me to imagine that we cannot get that done even on a faster pace than what the bill calls for.

WE DO SUPPORT RESEARCH OF THE HAND-HELD ELECTRONIC RECORDING

We do support research of the hand-held electronic recording, and I think that could be tied in with a computerized trade restructuring. All those trades would be entered, and they would be pretty much in order. You'd have who traded and what price, and I just think with today's electronics that we should be doing that, and very quickly.

WE ARE OPPOSED TO MOST DUAL TRADING UNTIL WE CAN DEVELOP AN ADEQUATE AUDIT TRAIL

Dual trading, we are opposed to most dual trading until we can develop an adequate audit trail, and I think there's been some provisions for some exemptions on the dual trading issue in the bill. We would agree with most of those as it pertains to spreads and that kind of thing.

WE SUPPORT FLOOR TRADER REGISTRATION

We support floor trader registration, and penalties we think should be adhered to strongly by the exchanges and be uniform. A major rule violation, first offense, should be 6 months' suspension and the second offense expulsion of a trader whenever they do that.

ETHICS

We believe in ethics, but we realize you can't dictate or legislate ethics. But I think they should be——

The CHAIRMAN. Be sure to enforce the rules.

Mr. FRICK. Yes. Thank you.

[The prepared statement of Mr. Frick follows:]

NATIONAL CATTLEMEN'S ASSOCIATION

1301 Pennsylvania Ave. N.W. • Suite 300 • Washington, D.C. 20004-1701 • (202) 347-0228

Headquarters:

5420 South Quebec Street • P.O. Box 3469 • Englewood, Colorado 80155 • (303) 694-0305



Testimony on Behalf of the

NATIONAL CATTLEMEN'S ASSOCIATION

regarding

S. 1729

The Futures Trading Practices Act of 1989

Before the

Senate Committee on Agriculture, Nutrition, and Forestry

submitted by

Jack Frick, Chairman, NCA Futures Subcommittee

October 17, 1989

 The National Cattlemen's Association is the national spokesman for all segments of the beef cattle industry -- including cattle breeders, producers and feeders. The NCA represents approximately 240,000 cattlemen. Membership includes individual members as well as 47 affiliated state cattle associations and 26 national breed associations.

Good morning, Mr. Chairman and members of this Committee. My name is Jack Frick, I am from Scott City, Kansas and currently serve as chairman of the Futures Subcommittee for the National Cattlemen's Association (NCA) and as the NCA representative on the Commodity Futures Trading Commission (CFTC), agricultural advisory committee. We at NCA thank you for the opportunity to express our views. In 1987-88, NCA appointed a task force charged with making recommendations to improve the contract specifications. Today, the NCA and the Chicago Mercantile Exchange (CME) continue working to achieve significant improvements in the cattle futures contracts.

There is always room for improvement as indicated by the FBI investigation and actions in the Board of Trade soybean pit publicized earlier this year.

We at NCA commend you for moving forward in a timely manner with hearings and the subsequent introduction of The Futures Trading Practices Act of 1989. NCA has a strong history of activity on CFTC reauthorization and related futures issues. The integrity of the markets is an absolute necessity if cattlemen are to use these risk management tools effectively.

Our comments today will address the bill titles as introduced:

Title I - Authorization of Appropriations

Permanent authorization of the CFTC with annual oversight hearings is supported by the National Cattlemen's Association. This permanency is long overdue and will allow the Commission to redirect some of its funds to accomplish the expanded tasks as outlined in the Futures Trading Practices Act of 1989. The five year extension proposal in the Act is a major step in that direction.

Adequate numbers of highly trained, qualified, experienced personnel are central to the accomplishment of any mission. NCA supports CFTC requests for increased personnel and funding, which have been outstripped by growth in the futures industry during recent years. On one specific issue, periodic verification of positions held by commercial traders as bonafide hedges is the type of information that increased surveillance should create.

Title II - Floor Surveillance and Dual Trading

NCA supports the concept of self-regulation by the futures industry with continued strong oversight by the CFTC. Strict adherence to the increased penalties proposed by the CME Special Committee to Review Trading Practices and other regulatory measures will be more meaningful than increasing the number of CFTC personnel on the trading floor. The concept of CFTC as a strong oversight regulator with adequate resources to monitor trading practices is a more viable concept than increased physical presence in the trading pits.

(2)

Commission Oversight -- As long as pit broker cards are bracketed into 30 minute segments, narrowing the audit trail for outside paper will be relatively meaningless. Increased audit procedures to cross-match information on a pit broker's card with the brokerage house's outside orders is supported by NCA. NCA supports increased research into the use of hand-held electronic recording devices or other emerging technologies to record pit broker transactions in lieu of the traditional hand recorded pit broker cards. The futures industry has committed research funds to develop this technology. NCA supports continued pressure from all sectors to assure the technology is developed and adopted.

The use of electronic systems in place of "open outcry" offers unlimited advantages in recordkeeping market surveillance, ease of use, and opens opportunities for additional refinement of Computerized Trade Reconstruction. NCA strongly encourages the exchanges to implement electronic trading systems during normal trading hours as an alternative to "open outcry" as these technologies become refined and perfected.

NCA supports the concept of separate time brackets for market openings and closings. Opening and closing of trading sessions often have a wide trading range. NCA recommends increased auditing to evaluate if fills for pit brokers are better than for outside orders. Statistical probabilities of equal treatment among pit brokers and outside trades are recommended for orders filled on the open and close.

Closer and more frequent monitoring of positions held by registered "commercial" traders is recommended to assure that those positions are in fact bonafide hedge positions. Auditing procedures may be required to establish that the commercial trader in fact has product or orders in the physical market that are being offset by hedge positions in the futures market.

Dual Trading -- NCA supports elimination of dual trading pending adoption of audit trail technology "capable of capturing transaction times independently precisely and completely." Currently, brokerage house orders are time-stamped going into and out of exchanges, but pit broker cards submitted for clearing are only indicated by 30 minute time-brackets. An accurate audit trail cannot be reconstructed with the 30 minute bracketing of pit broker cards. Elimination of dual trading is recommended across all commodities or those pits eliminating dual trading will be placed at a competitive disadvantage. Traders or associations wishing to continue dual trading will migrate to pits where it is allowed unless the practice is universally banned.

(3)

NCA is sympathetic to claims that elimination of dual trading could reduce volume traded in some contract months. At this time, however, it is believed that the loss of public confidence from allowing dual trading outweighs the potential gains from the additional liquidity provided by continuation of the practice. Producer confidence is paramount to their continued use of the markets.

Title III - Broker Associations

Public confidence in futures markets could be increased by disclosure of broker association membership. NCA supports membership disclosure and elimination of dual trading for individual traders and banning members of a broker association from trading for their personal accounts in all Exchange markets against orders executed by members of the same broker association regardless of profit sharing arrangements. Allowing dual trading to continue within broker groups but prohibiting it by individual traders places the individual trader at a comparative disadvantage while doing little to address the intuitive concerns associated with dual trading.

Title IV - Governing Structure

Strengthening self disciplinary committees will help restore integrity to the markets. Greater representation by non-floor membership is a necessary step. The CME currently appoints one non-voting member and two members each to the Live Cattle and Feeder Cattle Committees. NCA has had past representation on the CME Board of Governors. We encourage and support continued and increased representation on exchange governing boards and disciplinary committees.

NCA supports banning members committing any major rule violation or more than one minor rule violation within the last five years from serving on exchange disciplinary or oversight panels.

Title V - Floor Trader Registration

Any action to ensure that individuals operating as floor traders or brokers are legitimate will increase market confidence. As we have seen recently, a few bad apples can leave the public with the impression the whole bunch is rotten. NCA supports increased admission requirements. More comprehensive background checks coupled with a required formalized education program should be mandatory.

Title VI - Penalties

The concept of self regulation with strong CFTC oversight is supported by NCA. Without strict enforcement of penalties, regulation lacks the teeth to ensure compliance with self-imposed rules.

(4)

NCA supports the adoption of trading guidelines for rule violations as recommended by the CME Special Committee as follows:

- A. Major rule violations
 - 1. First offense - Six months suspension of all membership privileges; and
 - 2. Second offense - Expulsion.
- B. Minor rule violations
 - 1. First offense - Thirty days suspension of all membership privileges;
 - 2. Second offense - Six months suspension of all membership privileges;
 - 3. Third offense - One year suspension of all membership privileges; and
 - 4. Fourth offense - Expulsion.

Title VII - Assistance to Foreign Futures Authorities
No specific comments.

Title VIII - General Provisions

Ethics Training for Registrants -- The integrity of self regulation is directly tied to ethical standards. Extensive ethics training will establish both the seriousness and recollection of ethical standards.

Undercover Operations and Enforcement -- NCA communicated directly with CFTC chairman, Wendy Gramm, and urged complete and full cooperation as soon as the recently completed FBI investigation was publicly announced. Continued cooperation and participation by CFTC with other investigating agencies will increase public confidence in the integrity of futures markets.

In response to NCA activities, USDA and CFTC agreed on formal liaison activities in October 1987. Full cooperation by the CFTC with other regulatory and enforcement agencies will enhance the overall effectiveness of the regulatory effort.

The reauthorization is a lengthy process and we appreciate this committee's efforts. Our members share many of the same concerns you have heard from other market participants. Returning market integrity, in light of the recent investigation, and establishing CFTC as the futures regulatory agency are sought by everyone.

Mr. Chairman, NCA is willing to assist you as this process moves forward. I will eagerly entertain questions.

The CHAIRMAN. Thank you very much.

Harvey Joe Sanner, it's good to see you again. You have been in this room before many a time. Go ahead. We welcome you here.

**STATEMENT OF HARVEY JOE SANNER, NATIONAL PRESIDENT,
AMERICAN AGRICULTURE MOVEMENT, DES ARC, AR**

Mr. SANNER. Thank you.

I am Harvey Joe Sanner. I farm rice and soybeans in Prairie County, Arkansas, and I'm president of the American Agriculture Movement.

First of all, I want to commend you and Senator Lugar for what you're doing with this legislation. We vitally support it. I had a nice statement, but Senator Eagleton pretty well read it yesterday about the legislation.

The CHAIRMAN. He didn't mince words, did he?

Mr. SANNER. He did not. I like him. I may try to sign him up in AAM the next time I see him.

The CHAIRMAN. You have to be careful. Remember, they signed him up to be a public member of the CME board out there. [Laughter.]

At the next board meeting, someone may question who asked him to join. But one thing about Tom Eagleton that we found out, all of us who served with him, is that if he had a feeling, he said it. He used to give Democrats and Republicans alike holy unshirted hell when he felt it was necessary. So you may find that if you get him in there, he may do the same to you.

Mr. SANNER. He may be looking for a new home after yesterday.

ACCOUNTABILITY FROM THE CFTC AND THE CBOT IN THAT THE DECISIONS THEY MAKE SEEM TO HAVE ABSOLUTELY NO CONCERN FOR WHAT THE IMPACT IS ON AGRICULTURE

I want to talk to you about something a little different. Again, we support the legislation and commend you for what it has done, but there's an area that we're primarily concerned about that I don't think it addresses. That's accountability from the CFTC and the CBOT in that the decisions they make seem to have absolutely no concern for what the impact is on agriculture.

CBOT JULY 11 RULING

I got off a combine day before yesterday, combining in soybeans that were worth \$5.50. They were worth \$7.50 when the CBOT made the July 11 ruling they did. They should be worth \$9.50 if you look at stocks and past history. We've had hundreds of millions of dollars jerked out of the farm community due to that action on July 11. I'm hoping the committee will look into this issue as we move on down the road in examining how the CFTC and the CBOT acted.

We think we've been damaged far more than anything else this committee could do as far as rural development. If you look at the dollars we've lost in the farm community over that action that was condoned by the CFTC, I think we've seen more damage done to rural America than at any time since I've been farming. Hundreds of millions, possibly even billions of dollars. No one knows how

long it's going to take us to overcome this confidence that's been shook—lack of confidence, I might say, in the market now.

I've had letters and calls from all over the United States. I've had letters from the grain buyers in Russia, China, Germany, complaining about what happened on July 11 and how something needed to be done about it. So that's an issue that's really of concern to us. I am hoping that if we're going to have an agency like CFTC and we are going to fund them, they should have to consider what the impact is going to be on producers. After all, it is our livelihood, as Willis mentioned earlier.

We've heard a lot about risk transfer, that that's what the system is supposed to be doing, and it's done quite well. It's transferred all the risk to producers. That's what I see it doing. It's transferred all the risk, actually took the money out of farmers' pockets on July 11.

We've heard about the circuit breakers that they put in place. Well, fooling around in tractor sheds and all, I know normally when you have a circuit breaker to trip, you've had a dead short somewhere. I think we've seen some dead shorts in that marketplace.

So I would like to commend you for what you have done, and please go on and examine the impact on farmers and what it's meant to us. What are we going to do about this situation in the coming months. It's going to be devastating to farmers as lost income. It's going to push many of them out of business, this one simple act that they did. That needs to be addressed.

AS FAR AS AUDIT TRAILS, I'M MUCH MORE CONCERNED WITH THE MONEY TRAIL

As far as audit trails, I'm much more concerned with the money trail. I want to know where the money went. I want to know where those millions of dollars went that should have come to farmers. It went to someone else in that market. That needs to be determined. And I'd like to know how we're going to get it back into the farmers' pockets where it should have been to start with.

I realize we're talking about reauthorization of the CFTC here, and maybe these issues are somewhat aside. But, after all, if we're going to reauthorize them and they're going to do the same thing again, they're going to condone this kind of action without any regard to the farm community. I think the gentleman yesterday had a good point: Why do we need them? Let's let the SEC or someone else do this job. If they can't do a better job than what they've done for the farm community, I'd say take the money and spend it somewhere else. Put it on target prices. I can use it there.

Thank you, sir.

The CHAIRMAN. Thank you very much.

I think, as I said yesterday, that there are those who would like to just do away with the CFTC and put futures trading under the jurisdiction of the SEC. In many ways, this reauthorization is extremely important. If Congress and the public do not see a strengthened CFTC, one that can be aggressive and do the things that it's supposed to do, then there will be a movement in the Congress—ultimately successful—to do away with the CFTC. That's

why these hearings are extremely important. I thank you for being here.

I yield to Senator Lugar if he has any questions.

Senator LUGAR. I would just express my own appreciation to each of the members of this producer panel. Clearly, your thoughts have been reflected in what the chairman has said and what both of us have tried to say in the legislation. We speak for the farmers, for the public of this country. We are trying to maintain surveillance over CFTC and the exchanges. It is a busy process, as you observed. But we appreciate your own personal testimony as well as the participation of your organizations this morning.

The CHAIRMAN. Thank you, gentlemen. I apologize for your having to wait overnight, and I wish you all a safe trip back home.

I invite Charles Nastro, the chairman of the Coffee, Sugar & Cocoa Exchange; Donald Conlin, the chairman of the board of managers, New York Cotton Exchange; Michael Braude, the president and chief executive officer of the Kansas City Board of Trade; and James Lindau, the president of the Minneapolis Grain Exchange to come forward.

Gentlemen, as I said to the others, I am sorry we were unable to get to your testimony yesterday. Unfortunately, the Senate has a number of major issues before it which threw everything else off. I appreciate your willingness to stay over.

Mr. Nastro, let's start with you, sir.

**STATEMENT OF CHARLES P. NASTRO, CHAIRMAN, COFFEE,
SUGAR & COCOA EXCHANGE, NEW YORK, NY**

Mr. NASTRO. Good morning, Mr. Chairman.

INTRODUCTION

My name is Charles Nastro. I am the chairman of the board of the Coffee, Sugar & Cocoa Exchange in New York City. I am also an executive vice president and director of commodity administration at Shearson Lehman Hutton, Inc.

**OUR COMMITMENT TO MAINTAIN THE TRUST AND CONFIDENCE OF OUR
TRADING CONSTITUENCY**

Our exchange, founded in 1882, is the preeminent world market for trading futures and options in coffee, sugar and cocoa. Our contracts are heavily used by commercial interests engaged in the production, exportation, distribution and processing of these three commodities.

In order to maintain the trust and confidence of our trading constituency, we are committed to maintaining the highest standards of integrity.

Some years ago we installed a sophisticated computerized information system to support our compliance program and our market surveillance efforts. Last year, our board, recognizing that our needs had outgrown our capabilities, authorized the exchange staff to develop improvements. The board has authorized approximately \$5 million, representing over 20 percent of our total revenues for 1989.

**WE SUPPORT THE GOAL OF THIS BILL TO ENSURE THAT OUR MARKETS
MAINTAIN THE HIGHEST STANDARDS OF INTEGRITY**

We support the goal of this bill to ensure that our markets maintain the highest standards of integrity. In fact, we believe many of the bill's provisions are salutary.

CONCERN OVER SOME PROVISIONS OF THE BILL

However, we are greatly concerned that some of those provisions could sweep over small businessmen who have served the markets honestly and effectively and damage our competitive position.

The concern about foreign competition is important to us. Futures contracts in our commodities are traded on exchanges around the world. In fact, in London, that market trades sugar and cocoa contracts that are identical to ours. Right now, their cocoa volume almost equals ours. Commercial users of our exchange use those markets, and business can be diverted from our exchange to theirs in a matter of seconds.

We are not here to attack what you are trying to do but, rather, to work with you to achieve some of your goals. The bill is very complex. Since it has been introduced, there has not been sufficient time to understand all of its implications.

The bill would require that in 3 years all exchanges have in place systems that will record all trades by a source independent of the executing broker. We would be delighted to have such a system, but we have no way of being certain that what the bill is calling for is feasible.

The New York exchanges have been working on developing a trade recording system that would utilize a hand-held device whereby floor brokers could record their trades and have them timed electronically. We have no idea at this point whether the system will work. It may be that the system will prove to be a panacea, but it may also prove to be a failure.

Perhaps there are other solutions, but at this time we have no idea what their design would be. And, equally importantly, we have no idea what the cost would be. Our exchange is a small institution with annual revenues of approximately \$20 million. There are limits to what can realistically be expected from those resources. We hope that this committee does not impose a cost burden that only the largest and most powerful exchange can absorb, thereby perhaps destroying the smaller markets.

The bill would also make futures commission merchants, like myself, liable for violations committed by independent floor brokers whom they select to execute trades. If the futures commission merchant does not use "due diligence" in selecting a floor broker or in monitoring the execution of a trade by him, the futures commission merchant could be liable for punitive damages, which could be astronomical. The concept of "due diligence" in the selection of floor brokers is new and untried. No such burden exists on brokerage firms in the securities industry.

The potential exposure and risk of liability under this provision is such that many futures commission merchants may cease doing business with independent floor brokers and hire their own. The result would be that numerous floor brokers may be driven out of

business. The loss of these brokers could seriously and adversely affect liquidity in our markets.

SECTION 601

A third example is section 601; that would make all futures commission merchants, floor brokers and other commodity professionals liable for violations of the antifraud section of the statute as a result of negligence. This would have the effect of overruling judicial decisions holding that such liability should only attach where there has been willful misconduct or reckless disregard of the facts, which is the legal standard in the securities industry. Futures commission merchants may well decide that it is no longer worthwhile to do business with the retail public because the commission revenue does not warrant the increased risk and expense.

The bill would also ban a number of existing practices unless the CFTC takes affirmative action to permit them. These practices include: dual trading, which is more significant to the coffee, sugar and cocoa markets than perhaps any others. Unless the commission acts, the practice is banned. Simply, the Commission may not meet the time deadlines in the bill. Dual trading is not inherently evil. It has significant value. It should not be banned, but properly regulated.

SECTION 806

Finally, section 806 would require the CFTC to impose service fees on the industry. We support the provisions of the bill that would grant increased resources to the CFTC. But burdening the markets with the cost of those resources could have unintended effects by increasing costs of doing business. This could be of significance to our exchange because of the competitive position vis-a-vis London. Right now, several London markets are cheaper to do business on, and this cost spread could widen to our detriment. Prudence dictates that the potential impact of these added costs be carefully studied before the tax is actually imposed.

This is only a brief summary of some of the examples of the problems that we see. We, together with several other New York exchanges, are separately submitting a statement providing greater detail on these and other questions and issues. We respectfully urge that the members of this committee carefully consider the points that we are raising, and we hope the committee will have enough time before marking up the bill to report out a piece of legislation that will be both reasonable and effective.

Thank you.

[The prepared statement of Mr. Nastro follows:]

TESTIMONY OF CHARLES P. NASTRO, CHAIRMAN
COFFEE, SUGAR & COCOA EXCHANGE
BEFORE SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY

October 17, 1989

Good afternoon, Mr. Chairman. My name is Charles P. Nastro. I am the Chairman of the Board of the Coffee, Sugar & Cocoa Exchange in New York City. I am also Executive Vice President and Director of Commodity Administration of Shearson Lehman Hutton, Inc.

Our Exchange, which has been in existence since 1882, is a preeminent market in the world for trading futures and options in coffee, sugar and cocoa. Our contracts are heavily used by commercial interests engaged in the production, exportation, distribution and processing of these three commodities.

In order to maintain the trust and confidence of our trading constituency, we are committed to maintaining the highest standards of integrity in our marketplace. To that end, we are constantly reevaluating and improving our self-regulatory program.

Some years ago we installed a sophisticated computerized information system to support our compliance program and our market surveillance efforts, as well as the overall management of the Exchange. That system was praised at the time by the CFTC in testimony before Congress as being

the state of the art. Last year, well before the announcement of the Chicago investigations, our Board of Managers, recognizing that our needs had outgrown the capabilities of our system, authorized the Exchange staff to develop whatever improvements were necessary and budgeted the funds for the purpose. Earlier this year, the Board added further funding, so that the total amount dedicated to the systems upgrade is now approximately \$5 million, representing over 20% of our total estimated revenues for 1989. Further, in the past year we have greatly enhanced the size and capability of our compliance staff.

The industries we serve recognize the quality and integrity of our markets. In the last three years, our total trading volume has more than doubled, which we believe represents a solid vote of confidence from our market users.

We wholeheartedly support the ultimate goal of the bill before you now, which is to insure that all the United States futures markets maintain the highest standards of integrity. We believe that many of the bill's provisions are salutary. Indeed, we already have in place, and in some instances have had in place for a number of years, several of the requirements that the bill would impose. These include rules requiring broad diversification on our Board and rules designed to prevent conflicts of interests. In addition, our

audit trail presently meets the initial standards prescribed by the bill.

However, we are greatly concerned that some of the provisions of the Bill could sweep over our industry like a tidal wave, destroying ways of doing business that have existed for over a century, putting out of business small businessmen who have served the markets honestly and effectively, and damaging the competitive position of the U.S. exchanges as against the rapidly growing foreign exchanges that are vigorously striving to divert American business abroad. The concern about foreign competition is particularly important for this Exchange. For the most part the commodities we trade are produced outside the United States and shipped in international commerce. Futures contracts in our commodities are traded on a number of exchanges around the world. Most notably, the London Futures & Options Exchange trades sugar and cocoa contracts that are identical to ours, and their cocoa volume exceeds ours. All of the commercial users of our Exchange use the foreign markets regularly, and business can be diverted from our markets to theirs in a matter of seconds by a few strokes on a keyboard. We are part of what is truly a global marketplace. We must be able to compete, while at the same time providing market integrity and efficiency second to none in the world.

We are not here to attack what you are trying to do, but rather to work with you in order to achieve the goals we share. The bill is very complex. Its potential impact is enormous. In the few days since it has been introduced, there has not been sufficient time for the industry or the public generally to thoroughly digest and understand all of its implications.

Even on the basis of a very preliminary analysis, we have identified numerous questions and issues. In the few short minutes available to me today, I could not possibly explore them in any detail whatsoever. But let me call to your attention just some examples of the provisions that give us the most concern.

First, the bill would require that in three years all exchanges must have in place systems that will record all trades by a source independent of the executing broker. We would be delighted to have such a system in place, so that we could accurately pinpoint the time of execution of every transaction and immediately lock in all relevant details regarding the transaction. But we simply have no way of being certain that what the bill is calling for is feasible.

The New York exchanges have for months been working on developing a trade recording system that would utilize a hand-held device whereby floor brokers could record their trades and have them timed electronically. While we believe

that the devices will soon be available, we have no idea at this point whether the system itself will work. There has not been any feasibility testing. It may be that this system will prove to be a panacea. On the other hand, it may be a total failure. If it is a failure, what then?

Perhaps there are other technological solutions to the problem, but at this time we have no idea what their design would be and equally importantly we have no idea what the cost would be. It should be borne in mind that our exchange is a relatively small institution with annual revenues of approximately \$20 million. There are limits to what can realistically be expected from our resources. We assume that this Committee does not intend to impose a cost burden that only the largest and most powerful exchanges can afford to bear, thereby perhaps destroying the smaller U.S. markets.

We believe that, given the right circumstances, technological improvement of our audit trail will make our markets more efficient. But we must be sure that achieving technological success does not become a Pyrrhic victory. It makes no sense to develop a marketplace where no one trades.

To take a second example, the Bill would make futures commission merchants (including brokerage firms such as my own) liable for violations committed by independent floor brokers whom they select to execute trades. In

addition, if the futures commission merchant does not use "due diligence" in selecting a floor broker, or in monitoring the execution of a trade by him, the futures commission merchant could be liable for punitive damages, which could be astronomical. The concept of "due diligence" in the selection of floor brokers is new and untried. No such burden exists on brokerage firms in the securities industry. This provision raises a host of questions. For example, should an FCM refuse to use a floor broker who is registered by the CFTC and is extremely skillful in executing trades, but who has blemishes on his compliance record? How is a futures commission merchant supposed to "supervise" the execution of trades?

The potential exposure and risk of liability under this provision is such that many futures commission merchants (my own included) may cease doing business with independent floor brokers altogether and instead hire their own floor brokers on a salaried basis. The result would be that numerous floor brokers, who are now independent business men and women, will be driven out of business. The loss of these brokers, in addition to the injustice that it would work on them, could seriously and adversely affect liquidity in our markets. A loss of liquidity will make hedging on those markets less effective and thereby increase costs for our commercial market users.

A third example is Section 601, that would make all futures commission merchants, floor brokers and other commodity professionals liable for violations of Section 4b as a result of negligence. This would have the effect of overruling a long line of judicial decisions holding that such liability should only attach where there has been willful misconduct or reckless disregard of the facts, which is the legal standard applicable in the securities industry. The increased volume of litigation that will undoubtedly be engendered by this amendment would add significantly to the costs of what is already a very low-profit-margin business. Futures commission merchants may well decide that it is no longer worthwhile to do business with the retail public, which is where the bulk of the claims would arise, because the commission revenue simply does not warrant the increased risk and expense. In addition to depriving the retail public of access to the markets, this could also have the effect of reducing liquidity in the markets.

Another example of a provision causing great concern is Section 608, that would greatly expand the number and scope of infractions that would be classified as felonies. For the first time, it will be a felony to violate CFTC Regulations. There are hundreds of such regulations. Read literally, this provision could make it a criminal

offense for a customer to be late in filing a large trader report.

Another example is that the Bill would ban a number of presently existing practices unless and to the extent the CFTC takes action to permit them under prescribed conditions. These practices include:

- Dual trading, which is more significant to the coffee, sugar and cocoa markets than perhaps any other;
- The placing of oral orders, which presently constitutes a major portion of the orders placed by public customers on our Exchange;
and
- Trading between affiliated brokers, which may in some cases be the only way to get the best execution for a customer.

While it is true that the Commission may permit any of these activities, the bill would require affirmative action on the Commission's part to do so. In other words, unless the Commission acts, the practice is banned. This creates several problems. First, the Commission may not meet the time deadlines specified for it to act. Second, the Commission may well sense that it is under pressure not to make the required determinations, because the statutory bias

is against them. This makes it easier for the Commission to allow the practices to be banned in order to avoid criticism.

But dual trading, oral orders and trading between related brokers are not inherently evil. They all have significant potential value. They should not be banned. They should merely be properly regulated.

Finally, Section 806 of the Bill would require the CFTC to impose what are called "service fees" on the industry. We strongly support the provisions in the bill that would grant substantially increased resources to the CFTC. But burdening the markets with the cost of those resources could have unintended and undesired effects by increasing the costs of doing business on the U.S. exchanges. This could be of particular significance to our Exchange because of our competitive position vis-a-vis the London markets. Right now, several London markets are cheaper to do business on, and this cost spread could widen to our detriment. Prudence dictates that the potential impact of these added costs be carefully studied before the tax is actually imposed.

As I said, Mr. Chairman, this is only a brief summary of some of the principal examples of the problems that now we see in the Bill. We, together with several other New York exchanges, are separately submitting a statement providing greater detail on these and other questions and

issues. We will be very happy to work with you, the Committee and your staff members to address these issues in a way that will achieve the basic goals we mutually share, while avoiding unintended injury to our markets and their participants.

We respectfully urge that the members of this Committee carefully consider each of the points that we are raising, and we hope that the Committee will allow itself enough time before marking up the bill to receive detailed input from the public, to give it careful consideration and to report out a piece of legislation that will be both reasonable and effective.

I shall be pleased to answer any questions you or any members of the Committee may have.

The CHAIRMAN. Thank you, Mr. Nastro. I would suggest to you and the other witnesses to please feel free, within a reasonable amount of time, to add to your statement after we have heard the testimony. If there is something further that you would like to add, then send it to us. If the record is still open we will include it in the record. If it is not, we will make sure that it is noted and made available to the committee.

I mention this not just for you. It triggered my mind when you said that you had not had a chance to thoroughly analyze the bill. I can well understand that. Your exchange is not one that would have a bank of lawyers, accountants, and everybody else to look into this.

Please understand that both Senator Lugar and I, and in fact all of those who are concerned with this issue, want legislation that works. We do not want legislation simply for the sake of having legislation. To the extent that you have other ideas, you should not hesitate at all to send them directly to us here at the committee, and we will consider them.

We realize that there is a big difference between large and small exchanges. We will have some questions on this after the panel finishes. This is not the last chance you ever get to say anything. Obviously, if you have other ideas, send them on to us.

Mr. Conlin.

STATEMENT OF DONALD B. CONLIN, CHAIRMAN, BOARD OF MANAGERS, NEW YORK COTTON EXCHANGE, NEW YORK, NY

Mr. CONLIN. Good morning, Mr. Chairman.

INTRODUCTION

My name is Donald Conlin. I am chairman of the New York Cotton Exchange. At this time I would like to thank you very much for the opportunity to present a synopsis of our statement, which we will submit in detail later with your permission.

THE NEW YORK COTTON EXCHANGE

The New York Cotton Exchange is the oldest commodity exchange in New York, established in 1870. It is the world's leading marketplace for buying and selling of cotton futures. Our exchange provides a controlled, highly visible, and liquid marketplace for the trading of cotton futures and options contracts.

In addition to cotton futures and options contracts, the exchange and its affiliate the Citrus Associates of the New York Cotton Exchange, Inc., and its division, the Financial Instrument Exchange, provide a forum for trading of contracts for frozen concentrated orange juice futures and options, U.S. Dollar Index futures and options, European Currency Unit futures, Five-Year U.S. Treasury note futures and options, and a Two-Year U.S. Treasury note futures.

The New York Cotton Exchange has many unique qualities. Our trading volume in cotton is essentially generated by the industry trade. A review of our open interest positions reveal that 65 percent are held by trade interests. The marketing route for cotton starts with the farmer or grower who individually or through his

cooperative sells his crop to a large textile mill or merchant. Fluctuations in cotton prices are caused by various factors. Many of these factors, such as the weather, are beyond human control. The cotton futures and options market functions to provide a necessary means for risk management, and therefore enables individual cotton growers to safeguard against climatic calamities. In addition, the risk management function is enhanced by and is dependent upon investors willing to speculate upon the futures market.

The exchange has constantly striven to maintain active, liquid markets, where trading is conducted in accordance with rules and practices designed to assure fair, orderly, and competitive trading.

In response to published reports about investigation of possible trading abuses, our exchange was one of the first to appoint a special committee composed of our public members to review rules and procedures; examine disciplinary files; interview numerous members of staff as well as floor traders, floor brokers, commission houses and trade members, members of other exchanges and several persons of the Commodity Futures Trading Commission. A copy of the report of the Special Compliance Review Committee is attached to our full statement for your review. (See p. 498.)

SUPPORT S. 1729, WITH A FEW RESERVATIONS

The Cotton Exchange and the cotton industry support the adoption of the bill presently pending before this committee, S. 1729, with a few reservations.

Section 201 of the bill requires that each futures exchange to implement a new audit trail within 3 years. This new system, according to the bill, must be designed to record all transaction times independently, precisely and completely.

A very similar system is currently being considered among several of the exchanges. The New York Cotton Exchange is participating in its development. At the present time, however, technology needed to implement the system does not exist.

New technology requires extensive research, training, programming, and testing. In order to implement a system as complex as the one the bill would require, will necessitate a reasonable period for research and development. Setting a rigid timetable leaves a high degree of probability that major technological failures will occur. Corners will be cut at the system's testing stage which would produce a long-term effect of inefficiency. By allowing the system to be designed, created, and developed at a pace technologically feasible, minimum market disruption would be minimized, and the goals of the Senate committee would be achieved.

The New York Cotton Exchange welcomes the opportunity to assist the CFTC in ensuring strict compliance with standards set forth by this bill. We are determined to do everything technologically feasible in implementing a new system as rapidly as possible. The 3 years provided for in the bill, however, is of great concern. In lieu of the 3-year mandated timetable, the exchange recommends that no specific timetable be established, that the exchanges' progress in developing systems be monitored on a consistent basis by the CFTC, and the periodic reports be provided to the Senate Agriculture Committee.

The New York Cotton Exchange supports dual trading as an important and beneficial function of the exchange. Suspension of this privilege will significantly reduce trading volume. This will adversely affect liquidity. If liquidity is lost, a substantial amount of our market participants will be lost.

In markets such as those that trade on our exchange, which are very trade oriented, much of the speculative liquidity that comes to the market is provided by floor traders. For example, since we have a total floor population of 75 to 80 people in cotton, the elimination of dual trading dramatically decreases the volatility of the exchange inasmuch as the successful experienced broker would most likely opt to trade for his own account, leaving customer business for the most part to be handled by the least experienced brokers.

One of the goals of the exchange is to achieve and maintain the highest level of self-regulation. In attempting to reach this goal we have promoted continuous discussions between the exchange's compliance department and systems staff. Periodic checks of the system are conducted to ensure proper and efficient transaction times. While we are currently at a point of approximately 90 percent audit trail accuracy, we are continuously striving to improve this percentage.

Mr. Chairman, I just wanted to add one small thing in here. I heard testimony this morning relating to a 30 minute timing track on orders. On our exchange, if an order is received by a broker and he executes the order, he must note on his trading card the minute in which the trade was done.

So we are really timing within 1 minute right now; not less than a minute because it is not feasible to get into the seconds. But within a minute, every transaction is recorded. I just wanted to respond to that which I heard this morning.

And Mr. Chairman, the other thing we support is the sunshine rule in terms of boards. Our board, as an example, has currently six cotton merchants, three major mills, two co-ops. The co-op from California represents approximately 3,500 growers and 50 percent of the California cotton crop. The other co-op in Mississippi represents 2,500 growers or about 80 percent of the Delta crop.

In addition, on our board we have three commission house representatives, eight floor brokers, one CTA, and three public representatives at the current time. So I think our board is rather diverse.

Mr. Chairman, that concludes my testimony, and again I wish to express my appreciation for having the privilege of testifying before this committee. If there are any questions, I would be happy to answer them and provide any requested supplementary documentation.

[The prepared statement of Mr. Conlin and the report of the Special Compliance Review Committee follow:]

NEW YORK COTTON EXCHANGE

TESTIMONY OF DONALD B. CONLIN, CHAIRMAN
NEW YORK COTTON EXCHANGE
BEFORE THE COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY

October 17, 1989

Good Morning, Mr. Chairman, members of the Committee, and distinguished members of the audience. I am Donald B. Conlin, Chairman of the New York Cotton Exchange. At this time I would like to take a moment and thank you for the opportunity to appear here today and address the Committee. I have been Chairman of the Exchange for four terms, a member of the Board for approximately 25 years, and a member of the Exchange for 35 years.

The New York Cotton Exchange is the oldest commodity exchange in New York, established in 1870. It is the world's leading marketplace for the buying and selling of cotton futures. Our Exchange provides a controlled, highly visible, and liquid marketplace for the trading of cotton futures and options contracts.

In addition to cotton futures and options contracts, the Exchange and its affiliate the Citrus Associates of the New York Cotton Exchange, Inc., and its division, the Financial Instrument Exchange, provide a forum for the trading of contracts for frozen concentrated orange juice futures and options, U.S. Dollar Index futures and options, European Currency Unit futures, Five-Year U.S. Treasury Note futures and options, Two-Year U.S. Treasury Note futures.

The New York Cotton Exchange has many unique qualities. Our trading volume in cotton is essentially generated by the industry trade. A review of our open interest positions reveal that sixty-five percent are held by trade people. The marketing route for cotton starts with the farmer or grower who individually or through his cooperative sells his crop to a large textile mill, or a cotton merchant. Fluctuations in cotton prices are caused by various factors. Many of these factors, such as the weather, are beyond human control. The cotton futures and options market functions to provide a necessary means for risk management and therefore enables individual cotton growers to safeguard against climatic calamities. In addition, the risk management function is enhanced by and is dependent upon investors willing to speculate upon the futures market.

The Exchange has constantly striven to maintain active, liquid markets, where trading is conducted in accordance with rules and practices designed to assure fair, orderly, and competitive trading.

In response to published reports about investigation of possible trading abuses, our Exchange was one of the first to appoint a special committee composed of our public members to review rules and procedures; examine disciplinary files; interview numerous members of the Staff as well as floor traders, floor brokers, commission houses and trade members, members of other Exchanges and several persons of the Commodity Futures Trading Commission. A copy of the Report of the

Special Compliance Review Committee is attached to my remarks for your review.

The Cotton Exchange and the cotton industry support the adoption of the Bill presently pending before this Committee (S. 1729) with a few reservations.

Section 201 of the Bill requires each futures exchange to implement a new audit trail system within the three years. This new system, according to the Bill, must be designed to record all transaction times independently, precisely and completely.

A very similar system is currently being considered among several of the Exchanges. The New York Cotton Exchange is participating in its development. At the present time, however, the technology needed to implement such a system does not exist.

New technology requires extensive research, training, programming, and testing. In order to implement a system as complex as the one the Bill would require, will necessitate a reasonable period for complete research and development. Setting a rigid timetable leaves a high degree of probability that major technological failures will occur. Corners will be cut at the system's testing stage which will produce the long term effect of inefficiency. By allowing the system to be designed, created, and developed at a pace technologically feasible,

market disruption will be minimized and the goals of the Senate Committee will be achieved.

The New York Cotton Exchange welcomes the opportunity to assist the CFTC in ensuring strict compliance with the standards set forth by this Bill. We are determined to do everything technologically feasible in implementing a new system as rapidly as possible. The three years provided for in the Bill, however, is of great concern. In lieu of the three year mandated timetable, the Exchange recommends that no specific timetable be established, that the Exchanges' progress in developing systems be monitored on a consistent basis by the CFTC, and that periodic reports be provided to the Senate Agricultural^e Committee.

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In markets such as those that trade on our Exchange, which are very trade oriented, much of the speculative liquidity that comes to the market is provided by floor traders. For example, since we have a total floor population of seventy-five to eighty people the elimination of dual trading dramatically decreases the volatility of the Exchange inasmuch as the successful experienced broker would most likely opt to

trade for his own account, leaving customer business for the most part to be handled by the least experienced brokers.

One of the goals of our exchange is to achieve and maintain the highest level of self-regulation. In attempting to reach this goal we have promoted continuous discussions between the Exchange's compliance department and systems staff. Periodic checks of the system are conducted to ensure proper and efficient transaction times. While we are currently at a point of approximately ninety percent ^{audit trail} accuracy, we are continuously striving to improve this percentage.

As to Section 202(f) of the Bill, we respectfully suggest that some limited modifications will promote the interests of justice. This subsection concerns judicial review on behalf of a person affected by an order issued pursuant to subsection (b) of Section 202. Specifically, subsection (b) (4) authorizes the Commission to remove an officer, director, committee member, or employee of a contract market who:

- Fails to fulfill official responsibilities;
- abuses authority; or
- acts in a manner unfit for service in the official capacity.

This is an especially broad, and realistically speaking, unlimited grant of powers. Each employee of a contract market has his very livelihood and professional standing subjected to an infinite scope of

scrutiny and approval of the Commission. Although we are completely confident that this provision will never be brought into play with regard to our markets, we are compelled to note that anyone who is removed from his job should be afforded, at the very least, an opportunity to retain his or her livelihood and professional standing while contesting the Commission's action.

Subsection (f) does provide for judicial review but rather than expressly setting forth the terms and conditions of the necessary review it merely incorporates by reference Section 8a(9) of the Act. This section, which concerns the unrelated subject of market emergencies, provides for judicial review by the appropriate United States Court of Appeals. We certainly agree that an appeal to a United States Court of Appeals is proper and in conformity with the Act and its regulations.

On the other hand, Section 8a(9) limits the Court of Appeals' authority to stay an action until a determination, after notice and hearing before a panel of the Court, that the action complained of was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.

In the first instance, it must be recognized that this is an extreme limitation upon the authority of one of the United States Court of Appeals. This limitation is unwarranted when a person's livelihood

is about to be withheld during the course of what we all know will be a protracted and expensive litigation process. To require an individual to demonstrate that the Commodity Futures Trading Commission acted arbitrarily, or abused its discretion, or acted in an unlawful manner will generally function to prevent a stay except for the most egregious of circumstances. No one would contend that such a limitation provision is fair or just when a person's livelihood and means to fund an appeal are at stake.

Therefore, we suggest that the Bill expressly provide for appeals to the United States Court of Appeals and allow the reviewing Court to enter a stay upon the establishment of the following circumstances:

1. The petitioner's likelihood of prevailing upon the merits;
2. That the denial of the stay would cause irreparable harm to the petitioner;
3. That granting the stay would not endanger orderly trading or otherwise cause substantial harm to the Exchange or market participants; and
4. That granting the stay would not be contrary to the Act, and the Rules, Regulations and Orders of the Commission or in any way contrary to the public interests.

Mr. Chairman, this concludes my testimony. Again, I wish to express my appreciation for having had the privilege of testifying before this Committee. If there are any questions, I will be happy to answer them and to provide any requested supplementary information.

Thank You.

REPORT OF THE SPECIAL COMPLIANCE REVIEW COMMITTEEA. BACKGROUND.

The Board of Managers of the New York Cotton Exchange ("NYCE[®]") appointed a Special Compliance Review Committee ("Committee") to review the compliance and floor surveillance procedures of NYCE[®] and to recommend areas for improvement as part of the Exchange's self regulatory responsibility. The Committee consists of Read Dunn, Jr. as Chairman, J. D. Butler, Carl Anderson, (all public members of the Board), James V. Gargan, Esq., Exchange General Counsel and Michael R. Koblenz, Esq., Outside Counsel. The Committee was instructed to submit a preliminary and informal report to a Special Meeting of the Board on March 2, 1989 and a formal report to the regular meeting of the Board on April 6, 1989.

In carrying out its assignment, the Committee reviewed NYCE[®] By-Laws and Rules, the compliance manual; the floor surveillance and compliance procedures; examined disciplinary files; interviewed numerous members of the Staff as well as floor traders, floor brokers, commission houses and trade members, members of other Exchanges and several persons of the Commodity Futures Trading Commission ("CFTC"). The Committee restricted its study to the "customer protection" procedures because of the limited time available. This report summarizes the background, findings and recommendations of the Committee.

Assuring that members of the NYCE^(*) follow the By-Laws and Rules* is the initial responsibility of the Compliance Division. The Director of the Compliance Division reports to the General Counsel of the Exchange. Market Surveillance** is the responsibility of the Division of Surveillance, the Director of which reports to the President of the Exchange. The Compliance Staff and the Market Surveillance Staffs consists currently of 15 members.

The Compliance Division, seeks to protect the integrity of the market by surveillance on the floor, surveillance of trading records, by investigating complaints from members and customers; and by interviews with members and staff, and by review of computer records of trading members. If a violation is suspected the Staff conducts a detailed investigation.

If, after an investigation, it appears a violation has occurred, the staff prepares an "Investigative Report" which the Director presents to the Business Conduct Committee ("BCC"). The BCC reviews the Investigative Report with Staff. After its review, BCC may direct the Division to conduct further investigation.

* The By-Laws and Rules of NYCE^(*) are either prescribed by or approved by the CFTC.

** The focus of the report does not cover the functions of the Market Surveillance Staff.

The BCC may conclude no violation occurred or it may accept a settlement in which case the party in question neither admits or denies the allegation. In either of such cases the investigation is closed. If the BCC has reason to believe there was a violation but disciplinary action is not warranted it may direct a letter be sent to the party in question putting him on notice that the matter has been closed out, but reminding him of the Rule requirements and that if this activity is repeated the prior history will be presented to the BCC promptly. In more serious cases or ones in which settlement cannot be reached the BCC will cause a complaint to be filed with the Supervisory Committee which will proceed to hear the case.

The Supervisory Committee may conclude there was no violation and dismiss the case or it may issue sanctions which can include expulsion, suspension, fine and/or a cease and desist order. It may also accept settlements. Actions of the Supervisory Committee are final except in the event of expulsion, which is subject to the approval of the Board and thereafter may be appealed to the CFTC.

The Board also has the authority to expel any member which has been suspended on more than two occasions and/or fined in excess of \$50,000 on more than one occasion by any Disciplinary Committee of the Exchange within a four year period for violations of its By-Laws and/or Rules.

For the period 1982 to 1988, the BCC accepted forty-nine settlements which included one suspension of three years and eight cease and desist orders. The monetary settlements ranged from \$200.00 to \$15,000.

During the period 1982 to 1988 the Supervisory Committee issued twenty-one decisions and entered into thirteen settlements resulting in penalties. Of these cases, the Supervisory Committee issued sixteen suspensions from two months to two years, fines ranging from \$100.00 to \$75,000 and issued eleven cease and desist orders.

During the period 1982 to 1988 the Membership Responsibility Committee suspended trading privileges of six trading members and suspended one member firm.

B. COMMITTEE FINDINGS AND RECOMMENDATIONS.

1. Rules and General Information.

The Committee considered the By-Laws and Rules, general guidelines and operating procedures of NYCE[®] to be adequate and sufficient to detect most abuses in trade practice cases and to protect the integrity of the market. The Rules and procedures are similar to the other futures Exchanges and have been approved by the CFTC.

2. Staff.

The Staff of the Compliance Division is well trained and experienced. The Director was trained by the CEA which preceded the CFTC and has 15 years experience in compliance. From all accounts the staff is diligent in seeking to detect abuses, insofar as time and resources permit. Currently the Division is understaffed because of two vacancies and floor surveillance has consequently been reduced. A counsel has just been engaged to fill one of the vacancies and will report soon. A search is underway to add an additional person to floor surveillance.

The Committee recommends the staff be brought to full complement as soon as possible and that floor surveillance be intensified.

3. Audit Trail.

The key to effective surveillance is an accurate audit trail that will enable reconstruction of transactions. Data to match trades for clearing is generally good; the percentage of errors and out trades is not high, though, there is room for improvement. Data on the time of executions of contracts has been steadily improved, since the introduction of the requirement that transaction time to the nearest minute be noted on the trading cards, however, there is also room for further improvement in this area. Time is of such vital importance in the reconstruction of trades that every effort should be made to have this information conveyed accurately and promptly. Until such time as better electronic devices are generally available the time will still have to be noted visually and recorded manually on the trade cards by the traders and brokers in the ring.

The Committee recommends that efforts be intensified to achieve an audit trail which is at least 90% accurate.

4. Computer Surveillance

The present system of reconstructing and analyzing transactions manually from the brokerage runs is cumbersome and time consuming and limits the number and quantity of investigations.

The Committee recommends that the central clearing house computer be programmed in a manner that will permit reconstruction of trading to facilitate analysis.

Currently trade data is processed in three steps and considerable time is required for verification of transactions.

To reduce the possibility of error, the introduction of the "on line system" whereby the clearing house accepting the transaction enters into a central computer directly the trade data would be a distinct improvement. It is conceivable the "on line system" can also permit the time interval for the collection and entering of the trade data to be reduced. Any reduction in the time between the execution of transactions and the entry of this data for clearing will reduce the opportunities for willful and unintentional errors.

The Committee recommends the "on line" system be instituted in cooperation with other Exchanges.

5. Enforcement.

In general, enforcement procedures appear to be good and effective. Significant sanctions have been administered. It appears that such actions have deterred further violations. Repeat violations by the same persons after sanctions appears to be low. While there were no expulsions recently, several people gave up their membership after receiving sanctions.

Persons found guilty of customer abuse have generally received the more severe sanctions. Disciplinary actions for recordkeeping violations have tended to be relatively mild, especially in the case of first offenses and when no harm to customers is apparent.

The Committee recommends that more action should be taken for recordkeeping violations, especially for serious and repeated violations.

The Committee also recommends periodic review and report to the Board of the actions of the Floor Surveillance; Compliance Division, the Business Conduct Committee; and the Supervisory Committee. Such review on a regular basis could be accomplished by a special committee of the Board of Managers composed of individuals not serving on the BCC or Supervisory Committee.

C. MEMBERSHIP.

Currently an applicant for membership is required to submit statements in response to a questionnaire providing background information including financial net worth. This information is supplemented by statements from two sponsors and a personal interview. Approval for membership, however, rests primarily on the applicants ability to meet the Exchanges minimum financial requirements.

The Committee believes that maintaining high ethical standards of members of the Exchange is the best means of assuring the integrity of the system and of protecting customers from abuse.

The Committee recommends that the present system of obtaining information about an applicant be supplemented by an independent check not only of financial resources but, of credit rating, police records and record of violations on any other exchange. The Committee recommends that the Joint Audit Committee consider exchanging information with all futures exchanges regarding violations by traders and member firms.

The Committee also recommends the Membership Committee utilize its power to deny access to any individual, it believes is unfit to be a member. The Membership Committee should judge carefully the knowledge and levels of skills of persons applying for trading privileges.

1. Training.

Presently, the Exchange requires members seeking permission to trade pass an oral examination on trading. The Exchange does not have a training program as such. Training courses followed by written examinations to teach rules and regulations to new and prospective members that intend to trade on the floor whether for themselves or for customers would be helpful to assure that the rules are thoroughly understood and correctly implemented. Most new members admitted to execute orders have been clerks and are familiar with the general procedures, but may not be familiar with other Exchange or CFTC rules. Others applying to become members may have had no previous floor experience. In some cases where the person has no previous experience a period of observation of floor trading is required.

The Committee recommends the Exchange institute a training course for members in cooperation with other exchanges especially for members desiring to trade. It recommends that apprenticeship be considered for persons without sufficient experience.

The Committee strongly supports the proposal to institute courses in ethics for all members and recommends such a program be instituted as soon as practicable and in cooperation with other exchanges.

2. Education.

The Exchange has a public relations staff presently, which is engaged primarily in providing information to the public about contract performance and new contracts. Futures markets are not well understood by the public and in times of stress such as unusual price movements or adverse press accounts of market activity these markets are often subject to public criticism which may be based upon misconceptions and erroneous perceptions.

The Committee recommends that the Exchange assume some responsibility to explain the functions of futures markets. In dealing with broader questions of economic function and public benefit the economic departments of the colleges and universities and other resources should be enlisted.

D. SUMMARY OF RECOMMENDATIONS.

1. Floor Surveillance

(a) Fill the vacancy of the chief floor supervisor with an experienced person and intensify the program with emphasis on detecting the violations.

(b) Enforce more stringently requirements for submitting timely and accurately trade data to improve the audit trail.

(c) Study the possibility of shortening the interval for submitting data from trading cards.

(d) Institute "on line" computer system for inputting trade data directly and for immediate verification.

(e) Program computers to speed analysis of trade data and the reconstruction of trades.

(f) Efforts should be intensified to achieve an audit trail which is at least 90% accurate.

2. Enforcement.

(a) Appoint a special committee of Board of Managers to review periodically the activities of the Compliance and Market Surveillance Staff, the Business Conduct Committee and the Supervisory Committee.

3. Membership.

- (a) Strengthen membership qualifications.
- (b) Institute independent background checks.
- (c) Institute training program for new members.
- (d) Institute ethics training for all members.
- (e) Consider apprenticeships and/or supervisory program for new members.
- (f) Exchange of information with other futures exchanges regarding violations by traders and member firms.

4. Education.

(a) Strengthen the Public Relations Division and expand its function to include education efforts that explain the functions of futures contracts.

Respectfully submitted,
Read Dunn, Jr., Chairman
J. D. Butler
Carl Anderson

April , 1989

The CHAIRMAN. Thank you very much. We will have questions when we finish with the panel.

STATEMENT OF MICHAEL BRAUDE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KANSAS CITY BOARD OF TRADE, KANSAS CITY, MO

Mr. BRAUDE. Chairman Leahy, Senator Lugar, I also would point out to Mr. Frick that he does have a 1-minute guarantee in Kansas City. There is no big gap. We have voluntarily manually timed our trades to the minute for almost 10 years, and as testimony at the House committee showed, the CFTC has certified our audit trails accurate between 97 and 98 percent.

CFTC HAS DONE A GOOD JOB OF GOVERNING THIS INDUSTRY IN A VERY CHALLENGING PERIOD

I very much appreciate the opportunity to appear here today to give the Kansas City Board of Trade's views on this legislation. I have been president and chief executive officer of the Kansas City Board of Trade for 5.5 years, and it has been my experience that CFTC has done a good job of governing this industry in a very challenging period.

OUR EXCHANGE HAS ALWAYS AND WILL ALWAYS TAKE AN ACTIVE ROLE IN EFFORTS TO PROTECT THE INTEGRITY OF THE MARKETS

Our exchange has always and will always take an active role in efforts to protect the integrity of the markets. That is why we are eager to work with your committee to develop legislation toward this goal.

The Kansas City Board of Trade has long recognized that self-preservation demands a diligent effort to keep our house in order. Customer trust is the biggest asset we have, and we work hard to detect and punish any who would try to compromise that trust.

PERSPECTIVE OF A SMALLER EXCHANGE

I just want to basically talk about two provisions of the legislation. But before that, I want to stress that we think our appearance here is important because it seems to us this panel is the first opportunity to offer your committee a perspective on smaller exchanges in general and our exchange in particular.

Senator Leahy, you were quite correct. We have no big bank of accountants, lawyers or Washington staff. We are often overshadowed by our larger counterparts. I think it is regrettable that the GAO—

The CHAIRMAN. I noticed the smiles when I even mention the bank of lawyers.

IT IS REGRETTABLE THAT THE GAO, IN CONDUCTING THEIR STUDY, DID NOT COME OUT TO KANSAS

Mr. BRAUDE. Senator, I think it is regrettable that the GAO, in conducting their study, did not come out to Kansas. I don't believe they came to any of the smaller exchanges, but they did not come out to Kansas City.

I also would tell you that your committee, and certainly your staff, is always welcome in Kansas City, and we would invite you to come out. The House committee came out twice, and I think it was helpful to them in their deliberations.

NUMBER OF PRODUCTS AND VOLUME OF CONTRACTS TRADED

Now, one big difference, obviously, is the number of products and volume of contracts traded. The Kansas City Board of Trade currently has five contracts: an active Hard Red Winter wheat, options on that contract, grain sorghum futures, and Value Line and Mini Value Line stock-index contracts. To put things in perspective, our exchange's total trading volume in the last 5 years has averaged 6,810 contracts a day, about 2 percent of the average daily volume of some of the larger exchanges.

Our annual budget is less than \$5 million, less than the amount of money the two Chicago exchanges are spending on research on the hand-held instruments or less than the amount of money that some exchanges have spent on marketing new products.

THE KCBT IS KNOWN PRIMARILY AS A HEDGING MARKET FOR THE GRAIN INDUSTRY, A SERVICE WE HAVE RENDERED SINCE 1876

Now, there is another difference between the Kansas City Board of Trade and some other exchanges, and that is that since 1876, we have operated primarily as a hedging market for the grain industry.

Of the 88 firms represented by our members, 40 are directly involved in the production, distribution or processing of grain and at least 11 more firms represent those interests by handling mostly hedging accounts. Hedgers hold an average of about 90 percent of all open positions in our grain contracts.

In many ways, our small size and market composition gives us advantages. Through a combination of computerized and manual surveillance, we have developed an audit trail—that the CFTC has certified—that attains an average of better than 97 percent accuracy rate in verifying the time of trades to a 1-minute standard. Hedgers demand that market integrity, and we have no choice but to deliver.

In other ways, however, we face challenges as a small exchange. Just as any small business, we by definition have fewer resources relative to our larger, better-capitalized competition. Finding the most efficient solution to a problem is not only a desirable objective of the Kansas City Board of Trade, but it is a necessity as we go about the daily business of trying to figure out how to allocate resources.

AUDIT TRAILS AND FLOOR SURVEILLANCE

I want to talk about the audit trail and surveillance. First, we are in complete and unqualified agreement with the goal and the importance of an accurate audit trail. That is why we have placed an ongoing effort to support and improve our surveillance procedure. That is why, as a result of voluntary, 1-minute timing, we have achieved the better than 97 percent compliance with the current 1-minute standard.

Like the committee, we want an audit trail that is as accurate as possible, and we continually seek methods to improve it. We also agree that responsibility for setting the audit standard rests with Congress and the CFTC, with the CFTC retaining the ultimate authority to determine whether an exchange has met that standard.

However, we suggest that the method of achieving that standard has to rest with each exchange. While it is unclear to us what this legislation means by such terms as an "independent" source of recording all trades, and other finer points, what seems to be clear is that the legislation could require all exchanges to automate much of the trading function from receipt of the order to execution of the trade to notification of the customer.

In Kansas City, we are not afraid of automation. Many KCBT operations are completely automated, including price reporting and clearing functions. However, we don't consider automation in our case will be the appropriate case of action for all situations.

Every exchange faces its own issues—size, capitalization, physical layout, technical resources and others—in determining which mix of manual inputs and automation may best accomplish the goal. The customer will decide the rest. If the customer feels that complete automation best serves his purpose, he will take his business to exchanges that are completely automated.

By determining the system to meet the prescribed audit standard, the exchange can take into account its own unique characteristics. For us, a critical factor, obviously, is our size and the size of our member firms.

Many of our member firms are small regional operations, making them especially vulnerable to a forced plan of capital expenditures. Even the large multinational grain companies, represented in Kansas City, are sensitive to the costs of maintaining their Kansas City branch operations.

Recent legislative history shows that Congress shares our concern for small business. Through legislation such as the 1980 Regulatory Flexibility Act, Congress recognized the unique competitive situation facing small businesses, and mandated special treatment to protect the competitive ability of small firms. We feel confident that you will do the same here.

DUAL TRADING

Just a word on dual trading. We are pleased the legislation recognizes dual trading as a legitimate and necessary component of futures trading, especially at smaller exchanges like ours, where dual trading is vital to liquidity. The legislation reflects our position that dual trading should be allowed at any exchange that can demonstrate it can protect against abuses that may result from that practice, and we feel we can.

The CHAIRMAN. There is, of course, that kind of provision in the legislation.

Mr. BRAUDE. Yes, sir, we totally agree.

The CHAIRMAN. OK.

CONCLUSION

Mr. BRAUDE. Let me just finally summarize.

A headline in the October 9, 1989, edition of Securities Week states our concern most succinctly: "Senate Bill's Audit Trail Language May Give CBT, CME a Monopoly." For the Kansas City Board of Trade, and I am sure other smaller exchanges and our customers, that is the stuff of nightmares. We are certain such an outcome was not intended by this committee. Nonetheless the outcome is quite possible.

It also has been reported that this legislation serves as a springboard to fully automated futures trading and the dismantling of the open outcry system. By coincidence, just last Wednesday, our exchange entertained an official from the New Zealand Futures Exchange, a fully automated market.

Naturally, discussions of the two systems surfaced, and I would like to share with you a comment this official volunteered. Although he did not advocate one system over another, it was his perception that the loss of human interaction in automated markets hurts market liquidity.

Senators, we appreciate your efforts to assure that our system is the best system possible, and our comments are offered in this regard. We went into a lot more detail in our written testimony, and we hope you will review that.

Thank you for the opportunity to appear here today and listen to the cause of the smaller exchanges.

The CHAIRMAN. And I also got the message about your wanting somebody to come out and take a look at the Kansas——

Mr. BRAUDE. We really would.

The CHAIRMAN. I think you raise a good point, if we can do it. I have been out to the Minneapolis Grain Exchange.

[The prepared statement of Mr. Braude follows:]

TESTIMONY OF THE KANSAS CITY BOARD OF TRADE
OCT. 17, 1989
MICHAEL BRAUDE, PRESIDENT
before the
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
FUTURES TRADING PRACTICES ACT OF 1989

Chairman Leahy and distinguished members of the Committee:

I very much appreciate the invitation to appear here today to discuss the Kansas City Board of Trade's views on your legislation to reauthorize the Commodity Futures Trading Commission.

I am Michael Braude, president and chief executive officer of the exchange.

Let me preface these remarks by stating that since I joined the exchange five and a half years ago, my experience has been that the Commodity Futures Trading Commission has done an exemplary job of governing the commodities industry through a very challenging period in the industry's development: a time of phenomenal growth in trading volume, in numbers of products traded and in the diversity of instruments available.

The CFTC has done its job even though the agency, since its inception 15 years ago, has been forced to operate without the vote of confidence, clear mandate or budget dollars that permanent status would provide. That's easy to lose sight of in the current anxious environment. It's also easy to overlook that Congress has closely analyzed the CFTC's activities and agenda at least every four years during reauthorizations.

The Kansas City Board of Trade always has taken and always will take an active role in all efforts to protect the integrity of the markets. That is why we are eager to work with the Committee to develop legislation that achieves this goal. We think an important step is to make the Commodity Futures Trading Commission a permanent government agency. Congressional and CFTC resources invested in quadrennial reauthorizations could be much better spent on determining a mutually agreed-upon agenda for the agency.

We also think it is important to remember that the principles underpinning the existing commodity regulatory structure remain valid. Every crisis has its whipping boy, and this time the attack has been directed at the very essence of the commodity regulatory structure, the concept of self-regulation.

The Commodity Exchange Act established self-regulation in recognition of the fact that *absolutely no one* has a greater stake in honest markets than the futures exchange itself. In our American private enterprise system, dissatisfied customers vote with their pocketbooks; any exchange that disregards the welfare of its customers will soon be out of business.

The Kansas City Board of Trade has long recognized that self-preservation demands a diligent effort to keep our house in order. Customer trust is our single biggest asset, and we work hard to detect and punish any who would try to compromise that trust.

We respect the Committee's efforts to protect the public good, and we, too, are committed to using the tools that are reasonably available to reach this end. However, greed, dishonesty and simple error are part of human nature; neither

laws, nor advanced technology, nor micro-managed markets will change that fact. We continue to believe that those with the most to lose--the exchanges themselves--should retain the primary responsibility for deterring abuse, as well as the latitude to use effective deterrence methods that fit individual exchange circumstances.

Before addressing the specific provisions of this legislation, let me stress that we see our appearance here as especially important because today marks the first opportunity for us to offer to the Committee a perspective on smaller exchanges in general and the Kansas City Board of Trade in particular.

The smaller futures exchange often is overshadowed by its larger counterparts; regrettably, the General Accounting Office's recent reports on futures markets did not include an in-depth study of a smaller exchange, and Committee staff to date has been unable to accept our invitations to examine our operations.

While it's true that futures exchanges are all in the same business, the comparisons should stop there. Small exchanges are unique, with characteristics and challenges that differ greatly from the larger exchanges. Today, we would like to again invite you to visit the Kansas City Board of Trade to see these differences first-hand.

One difference, naturally, is the number of products and volume of contracts traded. The Kansas City Board of Trade currently has five contracts: an active hard red winter wheat futures contract and contracts on wheat options, grain sorghum futures and Value Line and Mini Value Line stock index futures. The exchange's total trading volume in the last five years has averaged 6,810 contracts daily, about 2 percent of the average daily volume of some of the larger exchanges.

The nature of business on our exchange is another difference. The KCBT is known primarily as a hedging market for the grain industry, a service we have rendered since 1876.

Of the 88 firms represented by our members, 40 are directly involved in the production, distribution or processing of grain and at least 11 more firms represent those interests by handling mostly hedging accounts. Hedgers hold an average of about 90 percent of all open positions in our grain contracts.

In many ways, our small size and market composition give us advantages. Through a combination of computerized and manual surveillance, we have developed an audit trail that attains an average 97-percent accuracy rate in verifying the time of trades to a one-minute standard. Hedgers demand market integrity, and we have no choice but to deliver.

In other ways, however, we face challenges as a small exchange. Just as any smaller business, we by definition have fewer resources relative to our larger, better-capitalized competition. Finding the most efficient solution to a problem is not only a desirable objective at this exchange, but a necessity as we go about the daily business of allocating resources where they are most needed.

We'd now like to address the key proposals in this legislation.

AUDIT TRAILS AND FLOOR SURVEILLANCE

Let me state first that the Kansas City Board of Trade is in unqualified agreement with the Committee on the importance of an accurate audit trail. That is why this exchange has in place an on-going effort to support and improve our surveillance

procedures. As a result of this effort, we were the first exchange to require a one-minute timing standard, and, as I mentioned earlier, we average 97-percent compliance with the current one-minute standard.

Like the Committee, we want an audit trail that is as accurate as possible, and we continually seek methods to improve it. We also agree that the responsibility for setting the audit standard rests with Congress and the CFTC, with the CFTC retaining the ultimate authority to determine whether an exchange has met the standard.

However, with due respect, we suggest that the method of achieving that standard should rest with each exchange. While it is unclear what this legislation means by such terms as an "independent" source of recording all trades, and other finer points, what is clear is the legislation would require all exchanges to automate the entire trading function, from receipt of the order, to execution of the trade, to notification of the customer that the trade has been executed.

The KCBT is not afraid of automation. Many KCBT operations are completely automated, including the price reporting and clearing functions. However, we don't consider automation the appropriate course of action for all situations.

Every exchange faces its own issues--size, capitalization, physical layout, technical resources and others--in determining which mix of manual inputs and automation may best accomplish the goal. The customer will decide the rest. If the customer feels that complete automation best serves his purposes, he will take his business to exchanges that are completely automated. The marketplace will force competitive exchanges to adapt or perish.

By determining the system used to meet the prescribed audit standard, the exchange can take into account its own unique characteristics. For us, a critical factor to consider is our size and the size of our member firms.

Many of these firms are smaller local or regional operations, making them especially vulnerable to a forced plan of capital expenditures. Even the large multi-national grain firms represented among our members are sensitive to the costs of maintaining their KCBT branch operations.

Small firms, like their larger counterparts, have little choice but to pass any increased costs on to their customers by raising transaction fees. However, because the smaller firms have a smaller customer base, their average transaction fee most likely would be higher than the larger firm's. In this business of largely undifferentiated services, customers naturally migrate to the lowest transaction fee, as they should.

What would result, however, is a very real threat to the viability of the smaller firm, many of which have been in our members' families for the better part of the last century. When our members are threatened, we are threatened.

Recent legislative history shows that Congress shares our concern for small business. Through legislation such as the 1980 Regulatory Flexibility Act, Congress recognized the unique competitive situation facing small business, and mandated special treatment to protect the competitive ability of small firms.

To this exchange's knowledge, no impact studies have been done or other special consideration given to small firms with regard to these proposals. Certainly, we have not been consulted.

Let's go back for a moment to the basis for this entire piece of legislation: protecting the welfare of the investing public. While the Committee has chosen to address those relatively few instances of customer abuse, many of them recent and still alleged, this legislation would set requirements that promise to change, and possibly damage, the structure of an entire industry.

As smaller brokerage and commercial operations are forced out of business, services are concentrated, competition wanes, and the customer has fewer choices. Likewise, if the smaller exchanges cease to exist, their contracts may die with them, restricting competition and the customer's investment options. This could pose critical problems for hedgers who rely on specific contracts to transfer risk.

Undoubtedly, futures transaction costs would be higher, a barrier to both the price-sensitive customer and to new firms looking to get into the business. The scenario could go on and on. The net effect would be reduced competition, increased costs and less-efficient markets, hurting the very public this legislation is intended to help.

Another point to consider is that as you move towards full automation, you move closer to the potential for disaster on a gigantic scale. The GAO itself recognized this possibility in its recent studies proposing increased automation. However, the GAO chose not to dwell on the consequences.

Unfortunately, the exchanges do not have the same luxury. Each exchange has to ask itself the very difficult questions of what happens if the order-taking system crashes? Or just part of it goes down? Or if the order were not properly communicated to a floor broker? Or if the market became particularly active and the system could not handle the required order flow? What if a competing interest tapped into another company's system? Perhaps disabling it? Who would have liability to the customer?

We agree wholeheartedly with the GAO, as stated in its September 1989 report to this Committee, that "automated systems . . . must be controlled to ensure that they do not reduce each exchange's ability to provide efficient, fair, and equitable treatment to all market participants." We respectfully submit that research on the implications of automation should have been completed before automated systems threatened to become law.

The industry is moving towards fuller automation, as it was even before the recent wave of anxiety over alleged trading abuses. But we are moving at a pace that allows us to consider the implications, research the alternatives and seek the best solutions for each of our particular trading environments. We continue to ask for that flexibility.

DUAL TRADING

We are pleased the legislation recognizes dual trading as a legitimate and necessary component of futures trading, especially at smaller exchanges where dual trading is vital to liquidity. The legislation reflects our position that dual trading should be allowed at any exchange able to demonstrate that it can protect against abuses that may result from the practice.

We do, however, reiterate our previous statement that the mechanism used to detect abuse must not be legislated because no law can take into account each exchange's circumstances, needs or financial resources.

As a note, we also think the definition of dual trading put forth in the proposal should be clarified; it is unclear whether the term "contract market," which appears a number of times, refers to a specific product or to all products offered by an exchange. Given the proposal's allowance for case-by-case exceptions when restrictions threaten market efficiency, we suggest the term should refer consistently to a specific product.

BROKER ASSOCIATIONS

Our opinions on broker associations are similar to those on dual trading. Broker associations in and of themselves are not a problem if an exchange has the mechanisms in place to detect rules violations.

If trading restrictions are put in place, great care must be taken in defining broker associations so the goal of discouraging abuse can be achieved without disrupting a market's efficiency. This is particularly important to small exchanges, where the supply of brokers is naturally more limited than at the larger exchanges.

We think the proposed legislation is unacceptably broad in its definitions of restricted associations. Would the legislation apply to two traders who merely use the services of the same floor clerk to reduce expenses, even though they are otherwise unaffiliated? Would it apply to independent traders who share office space to reduce rental costs? Would it apply to traders who have joint business arrangements or investments unrelated to the futures industry?

If such relationships were indeed defined as broker associations and if trading between the individuals were prohibited, liquidity at the Kansas City Board of Trade would be severely impaired. Again, this issue cuts to the very survival of a small exchange, where small firms and individual entrepreneurs must seek the most cost-efficient arrangements in order to stay in business. Given the relatively small number of floor brokers and independent traders at the Kansas City Board of Trade, such undue restrictions would severely damage our markets.

We think effective surveillance negates the need to enact these restrictions. But if trading among members of broker associations is to be prohibited, the definition of an association must be narrow enough to avoid damaging a market's competitive position. We suggest the CFTC, working with each exchange, define what types of affiliations should be regulated, taking into account the exchange's unique characteristics.

EXCHANGE GOVERNING STRUCTURE

In general, we are troubled by the tone of this entire section of the legislation. It should be remembered that futures exchanges, as organizational entities, remain part of the private sector. And while the integrity of the products and services rendered by the exchange and its members clearly is a matter of public concern, we believe the public interest is not well-served by the imposition of mandates on the organizational workings of the exchange.

We respectfully submit that the current system, which allows the exchanges to manage their day-to-day operations and handle problems with CFTC oversight, is the most effective and remains valid.

That being said, our exchange can accept certain specific provisions of this section. We have no problem with the provision requiring that 20 percent of the governing board consist of non-members; the Kansas City Board of Trade has, for many years, included two non-members on its 14-member board of directors, and we were the first exchange to elect a working grain producer to the board.

We do, however, respectfully disagree with the provision requiring non-member participation on certain disciplinary panels. Our problems with this proposal are twofold: determining and locating persons who are "qualified" to serve and protecting the confidentiality of information disclosed during disciplinary proceedings.

Disciplinary hearings often revolve around situations that are highly technical and not easily understood even by those familiar with the mechanics of futures trading. We question whether someone without expertise could serve effectively; such a person naturally would tend to defer to more-knowledgeable panel members, thus concentrating, rather than diffusing, their influence. The issue then becomes one of how to determine expertise and how to find an expert.

In many disciplinary proceedings, confidential information on specific market or financial positions must be disclosed. The exchange and the CFTC have recourse against any member who would violate the confidentiality of information received in a hearing, but would have little way to detect or punish such violations by a non-member.

Further, we respectfully submit that the provision requiring non-member participation is not needed to ensure unbiased findings. We think the CFTC has proven itself competent to serve as an impartial judge on disciplinary matters.

Another point with which we respectfully take issue surfaces in several sections of this legislation: the sweeping authority given to intrude into the employer-employee relationship. Existing CFTC regulations and exchange rules set forth which staff activity is prohibited; for instance, staff members may not trade in futures markets, nor can they control customer funds.

The CFTC has authority over the exchanges. The exchanges have responsibility for their employees. Why change a system that works?

RESTRICTIONS ON EXCHANGE RULE VIOLATORS

We have no problem with the principle of restricting members found guilty of certain violations from serving on governing boards and certain committees or disciplinary panels for a set period of time. However, we do think the exchange should retain the right to determine what violations are grounds for ineligibility.

Each exchange is charged with the responsibility to investigate and adjudicate possible rules violations. Each case is different, and because the exchange reviews each case in detail, the exchange is in the best position to determine the severity of the offense and the appropriate penalties. This includes the appropriateness of restrictions on board or committee service.

In testimony prepared for this Committee on September 8, 1989, Richard Fogel, Assistant Comptroller General, referred to the difficulties inherent in trying to make arbitrary generalizations about violations and appropriate penalties. Mr. Fogel said, and I quote, "...the universe of abuses is unknown and *the uniqueness and complexity of each case preclude an assessment of the adequacy and consistency of penalties* (emphasis added)."

We think Mr. Fogel's point is well-taken. We think the CFTC's current authority, in conjunction with the exchange's responsibilities, provides adequate tools to deal with violations without the need to establish arbitrary and mandatory "categories" before the fact.

EXCHANGE OBLIGATION TO NOTIFY CUSTOMERS

We share the Committee's desire to assure that customers who suffer financial harm from rules violations or trading abuses have recourse. Theoretically, a customer who is unaware of such harm has no recourse.

Nonetheless, we think the provision that obligates the futures exchange to notify customers will create more problems than it is intended to solve. While the idea on its surface may appear simple, a closer look reveals a Pandora's box of practical, legal and economic implications that must not be ignored.

The mechanics and the logistics of the notification process alone pose a host of practical questions. How to notify: by phone, by letter, by telegram? Where to notify: at home, in the office, on vacation? What is "prompt" notification: within the minute, the hour, the day, the week, the month? What actually constitutes notification: if the method is by mail and the letter is lost, has the customer been notified? If the method is by phone and a message is left, has the customer been notified? What if the customer cannot be reached? At what point does the obligation to notify cease?

We see an array of problems with this provision. A futures exchange does not maintain records on individual customer accounts; the firms handling the accounts have that responsibility. Under this provision, the exchange would have to develop a system to acquire and maintain records of customers who might have been affected by a violation.

Not all rules violations necessarily result in financial harm to customers. In fact, in some cases, it is difficult to determine whether any financial harm actually occurred.

Under this provision, exchanges would be required to reconstruct customers' trading activity, analyze the accounts, and try to determine whether the violation in question negatively affected the customers' positions.

The proposal also opens up a whole new arena of potential legal liability. The exchange potentially would be liable for the determination of financial harm, as well as for when notification wasn't made and should have been, and when notification was made and should not have been.

The practical issues cited above certainly would have an economic impact on exchanges. Although we are not able to estimate costs at this point, we think the resources required to develop a system of record-keeping, account analysis and notification would pose an undue economic burden on all exchanges. The increase in potential legal liability would exact additional costs.

CONFLICT-OF-INTEREST ISSUES

Because customer trust in our markets' integrity is the keystone of our exchange, we fully appreciate the need to avoid conflicts of interest as well as the mere appearance of such conflicts.

To this end, we already have in place a rule prohibiting the use or disclosure of material, non-public information obtained as a result of participation on a governing board or committee, as required by CFTC regulations.

However, we are concerned that requiring board or committee members to disclose market positions to other members would not have the intended effect.

Outside of official exchange deliberations, board and committee members are competitors in the marketplace. If a member is forced to disclose his and his

firm's positions to other members, his competitors gain a distinct psychological, if not competitive, advantage.

The legislation as currently proposed would discourage board or committee participation by perhaps the most qualified exchange members, to the disadvantage of the exchange, the customer and the futures industry.

Although the legislation acknowledges this potential problem, we think it is possible to develop a workable form of disclosure to other entities who would not compromise the confidentiality of trading information. We suggest the committee consider an alternative solution wherein a member is required to disclose positions to the exchange's compliance department who, along with the CFTC, would assess whether a potential conflict of interest existed. The use of a neutral party would meet the apparent intent of this proposal.

FCM RESPONSIBILITY FOR FLOOR BROKERS

As we have stated, the KCBT comprises a number of firms whose primary business is to fill orders for hedgers or the investing public. For many of these firms, especially the smaller ones, it is not cost-efficient to employ a full-time pit trader to handle orders.

For these firms, the ability to give orders to floor brokers is critical. The firms realize savings by paying commissions on a per-transaction basis, instead of absorbing the costs of salary and benefits. In addition, the firms, and ultimately their customers, are likely to receive the most efficient order fill because the transaction was handled by a professional pit trader whose livelihood depends on satisfied customers.

If futures commission merchants are held legally responsible for floor broker activity, many of these FCMs, especially the smaller ones, are unlikely to beef up their oversight of floor brokers, which is the apparent intent of this provision. Instead, most would cease to use floor brokers to avoid the specter of liability. Some firms might be able to justify employing traders directly, but others could well find it necessary to close their doors.

This is complicated further by the fact that many smaller FCMs send their orders to larger clearing FCMs for execution, with the clearing firm responsible for selecting the floor broker. Which FCM would be held liable in this situation?

On another note, without commissions earned from FCM orders, floor brokers would go out of business. At small exchanges such as ours, the presence and trading activity of floor brokers is critical to market efficiency, a fact recognized by this Committee in its provisions on dual trading.

In our opinion, this provision is unnecessary. Customers already have the means, through the courts, the CFTC or the National Futures Association, to seek redress against parties to a questionable transaction. The customer is protected and the markets are allowed to work.

CONSISTENT PENALTIES AMONG EXCHANGES

We respectfully take issue with the concept of making penalties for rule violations consistent among the exchanges. As you will recall, the GAO itself acknowledged that the uniqueness and complexity of each individual case precludes this. We agree.

EXCHANGE SERVICE FEES

The KCBT accepts the principle that each exchange should be responsible for a *fair share* of the costs of protecting market integrity; service fees, in fact, are part of the existing regulatory structure.

However, we respectfully submit that CFTC resources, and consequently services fees, should be allocated to each exchange based on some quantifiable standard, such as trading volume.

Currently, service fees are based on 65 percent of the average annual cost of compliance reviews. We are of the opinion that smaller exchanges are being allocated a disproportionately large share of CFTC resources, and thus, are paying a disproportionately large share of service fees.

For example, the Kansas City Board of Trade's 1989 service fee is scheduled to be about 26 percent of the fee paid by the larger exchanges; yet the KCBT's daily trading volume is less than 2 percent, on average, of the volumes at those exchanges. Further, we understand that our current audit trail accuracy rate is well above average and is among the highest of any exchange.

As exchanges continue to improve their audit systems, they obviously will be incurring additional, as yet unknown, internal costs. Also, as the CFTC adds resources as mandated in this legislation, their costs, as well as our proportional share, also will increase.

GAO STUDY OF DELIVERY POINTS

The Kansas City Board of Trade welcomes authoritative research on physical or cash-settlement delivery mechanisms and any other data that help us develop better, more competitive contracts.

However, we take extreme issue with this study if its purpose goes beyond the informational to a potential requirement for change. The delivery mechanism, along with contract size, trading unit and deliverable grade, are features of a particular contract--part of the product design. Like a car, a toy or a frying pan, a futures contract that is poorly designed in any significant way will fail, allowing a competitor to improve the product and make it successful.

Speaking from personal experience, an exchange spends a considerable amount of time during product development trying to determine the most appropriate terms of delivery for a particular contract. This usually involves extensive consultation with commercial operations, producers and academia. If the delivery mechanism is inappropriate, the contract will not attract the hedgers critical to its success, and it will fall on its face.

In addition, every contract submitted to the CFTC for approval must pass stringent tests regarding the delivery mechanism--and every other significant feature. When the contract begins trading, the delivery mechanism is tested once again every delivery period. The market lets us know in no uncertain terms whether the delivery mechanism works.

We feel unequivocally that a contract's delivery mechanism should remain a province of the exchanges, subject to CFTC approval.

CONCLUSION

Despite their imperfections, the futures markets work. If they did not, older markets would not have survived and grown, and new ones would not have proliferated. The U.S. futures markets are the envy of the world.

Can they work better? Of course. The intent of this legislation is towards that end: to improve on the existing system to assure the most efficient, fair and effective markets possible.

But before any action is taken, two critical points must be considered. First, will the action result in demonstrable improvement? And if so, at what cost?

We respectfully submit that numerous proposals in this legislation would lead to little demonstrable improvement at the Kansas City Board of Trade and most certainly would create an economic hardship on this exchange and its smaller member firms. In some instances, we can foresee a hardship so severe as to threaten our very existence.

A headline in the Oct. 9, 1989, edition of *Securities Week* states our concern most succinctly: "Senate Bill's Audit Trail Language May Give CBT, CME a Monopoly." For the Kansas City Board of Trade, other small exchanges and our customers, that is the stuff of nightmares. We are certain such an outcome was not intended by this Committee. Nonetheless, the outcome is quite possible.

It also has been reported that this legislation serves as the springboard to fully automated futures trading and the dismantling of the open outcry system. By coincidence, just last Wednesday, our exchange entertained an official from the New Zealand Futures Exchange, a fully automated market.

Naturally, discussions of the two systems surfaced, and I would like to share with you a comment this official volunteered to one of our staff members. Although he did not advocate one system over another, it was his perception that the loss of human interaction in automated markets hurts market liquidity.

We respect the Committee's efforts to assure that our system is the best system possible, and we offer these comments in that regard.

Thank you for the opportunity to appear here today.

The CHAIRMAN. Mr. Lindau.

**STATEMENT OF JAMES H. LINDAU, PRESIDENT, MINNEAPOLIS
GRAIN EXCHANGE, MINNEAPOLIS, MN**

Mr. LINDAU. Mr. Chairman, Senator Lugar, members of the committee, my name is James Lindau. I am president of the Minneapolis Grain Exchange, and we would more than welcome your return visit at any time.

INTRODUCTION

The Minneapolis Exchange was founded over 100 years ago, and it continues to be one of the most active, if not the most active cash grain market in the United States. In addition, we have a vital, although comparatively small, Hard Red Spring wheat futures market, with options on that contract. This futures contract provides the only true hedge for farmers and growers and users of Spring wheat in Minnesota, North and South Dakota and Montana.

**WE JOIN THE LARGE EXCHANGES IN SUPPORTING A REVIEW OF THE
SELF-REGULATING PROCESS THAT HAS WORKED WELL FOR THE LAST
CENTURY**

We join the large exchanges in supporting a review of the self-regulating process that has worked well for the last century. We readily admit that it is not perfect, and while perfection is our goal in auditing trades, we dare not let the pursuit of an impossible goal destroy the liquidity that is the lifeblood of every contract in every exchange in the world. In introducing the bill, Mr. Chairman, you said, "We have kept one goal consistently in mind—design a workable system that is efficient, effective and fair."

CONCERN

As one who is responsible for the successful operation of a small exchange, I am especially concerned about the language dealing with floor surveillance and dual trading, particularly with your reference to a "workable" system, Mr. Chairman.

96.8 PERCENT ACCURACY FOR THE EXCHANGE

The CFTC in its 1988 Rule Enforcement Review of the Minneapolis Grain Exchange, found that the exchange's 1-minute timing system was extremely accurate. The Commission states, "* * * the exchange's overall average accuracy rate was 96.8 percent."

**WE HAVE TAKEN ADDITIONAL STEPS TO ENSURE EFFICIENT, EFFECTIVE
AND FAIR TRADING**

Even with that positive review, we have taken additional steps to ensure efficient, effective and fair trading. We have substantially increased our floor surveillance and trade practice investigations, both in terms of numbers of personnel and qualifications for the jobs. We have reinforced the constant surveillance of the pulpit personnel who report and record the trades as they take place. We will increase the frequency of trading card collection and we con-

tinue to record every trade to the minute that it trades. Our Futures Trading Conduct Committee takes its responsibilities very seriously, imposing judicious penalties upon rule violators.

IMPOSING THE 3-YEAR USE OF TECHNOLOGY

The bill before you imposes upon all exchanges within 3 years, the use of technology that does not now exist and development costs that cannot even be estimated. The Chicago exchanges have earmarked \$5 million to start developing this technology. For the Minneapolis Grain Exchange to develop this technology independently would create a financial challenge that we probably could not meet. To make us dependent upon the generosity of America's largest exchanges, our friendly competitors, is potentially anticompetitive, and we suspect it could put us out of business.

Little has been said about the effect of this technology upon liquidity. Even the most optimistic analyses of electronic trading deal only simplistically, if at all, with issues such as viruses, overloads, or service interruptions. Any cost of widening of the spread between bid and ask prices comes directly from the customer. The cost to the marketplace could be staggering.

PERMIT ME A FEW COMMENTS ABOUT DUAL TRADING

Permit me a few comments about dual trading. Dual trading is essential to preserving liquidity in our futures contracts. Dual traders are involved in every aspect of futures trading at the Minneapolis Grain Exchange. They cannot be separated from trading in the current option, or spreading against deferred options, and permit any semblance of liquidity. If dishonesty springs from dual trading, we must increase our vigilance to prevent it—even though there is no evidence of dishonest dual trading in the Minneapolis Grain Exchange. If dishonest dual trading springs from highly liquid, active futures markets, let us identify and punish the dishonest traders, but let us not, in the process, destroy the futures markets. America's futures markets have been the best, and often the only, source of price discovery and margin protection since the Civil War. We urge you, as you consider this legislation, to be concerned about this fragile imponderable, liquidity. We implore you to be sensitive to the limited financial resources of the small exchanges, of which Minneapolis certainly is one.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Lindau follows:]

T E S T I M O N Y

of

JAMES H. LINDAU
President
Minneapolis Grain Exchange

on

S. 1729, FUTURES TRADING PRACTICES ACT OF 1989

United States Senate
Committee on Agriculture,
Nutrition, and Forestry

October 17, 1989

Mr. Chairman, Members of the Committee,

My name is James Lindau. I am President of the Minneapolis Grain Exchange. This exchange, founded over 100 years ago, continues to be one of the most active, if not the most active cash grain market in the United States. In addition, we have a vital, although comparatively small, hard red spring wheat futures market. This futures contract provides the only true hedge for growers and users of spring wheat in Minnesota, North and South Dakota and Montana.

We join the large exchanges in supporting your review of the self-regulating process that has worked well for the last century. We readily admit that it is not perfect, and while perfection is our goal in auditing trades, we dare not let the pursuit of an impossible goal destroy the liquidity that is the life blood of every contract in every exchange in the world. In introducing the Bill, Mr. Chairman, you said, "We have kept one goal consistently in mind -- design a workable system that is efficient, effective and fair."

As one who is responsible for the successful operation of a small exchange, I am especially concerned about the language dealing with floor surveillance and dual-trading, particularly with your reference to a "workable" system, Mr. Chairman.

The CFTC in its 1988 Rule Enforcement Review of the Minneapolis Grain Exchange, found that the Exchange's one minute timing system was extremely accurate. The Commission states, "... the Exchange's overall average accuracy rate was 96.8 percent."

Even with that positive review we have taken additional steps to ensure efficient, effective and fair trading. We have substantially increased our floor surveillance and trade practice investigations, both in terms of numbers of personnel and qualifications for the jobs. We have reinforced the constant surveillance of the pulpit crew who report and record the trades as they take place. We will increase the frequency of trading card collection and we continue to record every trade to the minute that it trades. Our Futures Trading Conduct Committee takes its responsibilities very seriously, imposing judicious penalties upon rule violators.

The Bill before you imposes upon all Exchanges within 3 years, the use of technology that does not now exist and development costs that cannot even be estimated. The Chicago Exchanges have earmarked \$5,000,000 to start developing this technology. For the Minneapolis Grain Exchange to develop this technology independently would create a financial challenge that we probably could not meet. Making us dependent upon the

generosity of America's largest exchanges, our friendly competitors, is potentially anti-competitive and could put us out of business.

Little has been said about the effect of this technology upon liquidity. Even the most optimistic analyses of electronic trading deal only simplistically, if at all, with issues such as viruses, overloads, or service interruptions. Any cost of widening of the spread between bid and ask prices comes directly from the customer. The cost to the marketplace could be staggering.

Permit me a few comments on dual-trading. Dual-trading is essential to preserving liquidity in our futures contracts. Dual-traders are involved in every aspect of futures trading at the Minneapolis Grain Exchange. They cannot be separated from trading in the current option, or spreading against deferred options, and permit any semblance of liquidity. If dishonesty springs from dual trading, we must increase our vigilance to prevent it (even though there is no evidence of dishonest trading at the Minneapolis Grain Exchange). If dishonest dual-trading springs from highly liquid, active futures markets, let us identify and punish the dishonest traders, but let us not, in the process, destroy the futures markets. America's futures markets have been the best, and often the only, source of price discovery and margin protection since the Civil War. We urge you, as you consider this legislation to be concerned about this fragile imponderable, liquidity. We implore you to be sensitive to the limited financial resources of the small exchanges.

The CHAIRMAN. Let me follow up on what you just said, Mr. Lindau. The question will be the same for everybody here.

You are concerned about the cost of having to develop this technology yourself. Certainly, we share that concern. Nobody is trying to impose excessive burdens on small exchanges. You said that you thought it would be anticompetitive to work with or to rely on the large exchanges for their technology.

Why is that? If technology is developed by the larger exchanges, why would it be anticompetitive if you found that you could use some of the same technology?

We see this all the time. A computer company may develop a computer system for its own use, but then we'll see small companies, small businesses around the country using sometimes basically the same computer systems—except pared down, of course—that a very large company is using.

Mr. LINDAU. Mr. Chairman, a lawyer whispered in my ear "anti-trust" at one point in this discussion, and it got my attention.

The CHAIRMAN. If I were in your place, it would get mine, too.

Mr. LINDAU. But I am more concerned about the possibility of having to rely on the technological advances that are made by our competitors, and as I mentioned, although the competition is friendly, they are competitors. We have no contract that assures us that they would share their technology. And to put us in the position of relying on that is frightening.

The CHAIRMAN. Well, haven't they said that they are willing to share the technology?

Mr. LINDAU. They have indicated that, that they would, yes, and I was pleased that that was made on the record yesterday because maybe there is a contractual agreement that we can impute to that comment.

A lot has been said about what happens in 3 years if this bill is imposed. My concern is that if you were President Bush, signing this bill today, what would I do tomorrow? My choices would perhaps be to go to Control Data and ask them to develop some kind of hand-held device for me, or take my hat in hand and go to the Chicago Merc and the Chicago Board of Trade and implore them to share their technology with me—or, third, perhaps, start the dissolution of our business.

All three of those choices are very difficult and frightening to me.

Mr. BRAUDE. Mr. Chairman, speaking for the Kansas City Board of Trade, I think from a little different perspective, we don't have any problem with the Chicago exchanges sharing their technology. We have a long history of very close cooperation with the Chicago Board of Trade, and in the past they have shared a lot of technology with us, and I have no fear that they would willingly and gladly do this.

Our fear, rather, is not the development; it is the cost of the implementation. The cost of the implementation of that technology could take up to 40 percent of our annual budget. I'm sure the Chicago Board of Trade would willingly share with us, but I think we would have to take a long look at if we could afford to implement that.

The CHAIRMAN. Gentlemen, do either of you want to add to that?

Mr. NASTRO. The only point, Mr. Chairman, about technology, we would welcome the Chicago Board of Trade being willing to hand over technology work that they have done, but we have to be sure it is compatible with each particular exchange, all these small exchanges, and that would be an additional cost as well.

The CHAIRMAN. Mr. Conlin.

Mr. CONLIN. Each exchange has its own clearing systems and its own methods of trading. I am sure that those methods could be standardized if this kind of technology is developed. I think our problem is the mandated time period. I think there is no argument with the fact that the world does change and that we will ultimately probably come into this kind of technology. It is just a question of the timeframe.

The CHAIRMAN. Thank you.
Senator Lugar.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. Mr. Chairman, I just wanted to make a comment or two because this testimony was very, very helpful.

First of all, it seems to me that each one of you have made that point that there are dramatic differences in the sizes of exchanges. A volume of 2 percent of the volume of what is occurring on one of the Chicago exchanges is certainly a dramatic difference. I have no doubt that as we get into the markup, we will take this into consideration.

I just simply wanted to say from my own personal viewpoint that while there are dramatic differences, at the same time there is the dramatic sameness of the desire for integrity for the customer whether he is dealing with a small exchange or a large one. And there has to be a degree of common sense in terms of cost and expense. It is certainly not the intent of this committee to put people out of business. Our objective is to increase the business and the confidence in the business. From your testimony, there are dramatic differences in accuracy rates. In the case of Kansas City exchanges a 97 or 98 percent accuracy rate and, in Minneapolis a 96.8 percent accuracy rate. That was not the kind of reading we got from some of the larger exchanges, as GAO looked at their operations.

I think some of us found it very difficult to find acceptable 80 percent to 85 percent accuracy. This means on a large volume of trade, many thousands of trades in which it is really not clear exactly when the report was made or whether one could put great credibility into the transaction. And when on top of that there were allegations of fraud and abuse of customers, and a very incomplete audit trail, I think you would understand why this committee is concerned on behalf of customers and the integrity of the situation.

I had a visit from a manufacturer of engines in my State who was concerned about the Clean Air Act, recognizing that this is an entirely different arena, it has some analogies. As the House committee and now the Senate committee is now acting on that legislation, they are taking a look at some major changes in technology

for people in the automobile industry or people making engines. The manufacturer that I visited with said that the requirements of the California standards currently in place, that have now come into play at least in the House legislation, are beyond his current technology.

On the other hand, he also made the statement, as some of you have, that within a 5- or 10-year period of time in the competitive world economy, he will have to be meeting those higher standards. He understands that it is not an argument that because he has an engine that works right now that the same engine is going to be competitive 5 or 10 years from now. What he was pleading for was a two-stage standard requiring some changes by a certain stage and another standard within another timeframe. He was pleading that we not go year-by-year, such as 2 percent at a time, but to recognize that there are large changes involved in the technology and that there be a timeframe in which this could occur.

I see our problem in a practical way—and I plead for your understanding as you have mine—that in the past, we have said let's allow the CFTC to review the industry and monitor year-by-year how things are working out. Now, as you heard yesterday this committee has some loss of confidence in how well the CFTC is doing that. And on behalf of the public as a whole, we're not altogether confident how rapidly the exchanges are making changes. Our predicament is to try to enact legislation that makes certain that progress will occur. We hope to beef up the CFTC—that's a good part of the exercise—with more staff, more money—everything that we think is in the public interest. We also hope the exchanges will work harder to police themselves.

But we are grappling with a situation in which we believe the public demands that somebody take charge of this situation, and we're trying to do it in a way that does not put people out of business in the process, or create programs that are entirely unfeasible.

All of these points I mentioned were triggered by what you have said about differences between exchanges, and clearly there is a difference. Our bill has tried, at least in words of art, to say we don't ban dual trading if you have an audit system that gives confidence. If you don't have an effective audit trail system and you have dual trading, we just perceive that that is open to some abuse, and common sense suggests that the public also sees things from that perspective.

So I really have no questions of you. I just simply want to observe that we hear you loud and clear, and it is important testimony and has to be reflected in the legislation, and I believe it will be. But we really need your technical guidance. Having made the point that small exchanges are different, and dramatically so, I suspect as we craft the final product, we need some guidance as to effectively recognize those differences. We have offered this invitation and we appreciate the testimony already given, but I would reiterate the chairman's invitation to work more with us, in view of the testimony of large exchanges, small exchanges, producers and so forth that these hearings have produced.

Mr. BRAUDE. Senator, I would comment that your committee staff has been very cooperative. Jim Lindau and I talked to the staff yesterday afternoon to set up a meeting prior to markup to

meet with the staff to try to give them our views specifically, and Mr. Ackerman was very helpful in that regard, and we do plan to have that meeting.

Senator LUGAR. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen. And again, as I said at the beginning, if you have further ideas, please send them to us. The reason for these hearings is to gather information. The markets work if they are credible, and we can do a lot to make them credible. But we want to have a credibility because it is actually working. We are not looking to impose any kind of artificial standard for show. Neither of us is interested in that. We want the markets to work well, to maintain their credibility, and to remove abuses. I suspect that all four of you concur in those goals, so we will work together to achieve them.

Thank you.

Our next panel includes John Damgard, president of the Futures Industry Association; Robert Isaacson, Principal, Commodity Investment Consultants, representing the National Association of Futures Trading Advisors (NAFTA), from San Francisco, California—and we probably did you a favor by keeping you here last night—Barry Lind, chairman of Lind-Waldock & Company in Chicago, and Robert Wilmouth, president of the National Futures Association.

I would say, Mr. Isaacson, that I don't mean to be flippant on that point. I hope that all your friends, family and associates are safe out there. The pictures that I saw this morning at around 5:30 of the damage in the San Francisco area were just absolutely terrible.

Mr. ISAACSON. Thank you. I have not been able to get through to them yet, but I assume they are OK.

The CHAIRMAN. Apparently, it is easier getting calls out than calls in. One of the networks last night was doing a self-congratulatory thing—as networks do when they are covering news and have to break into commercial programs. They were talking about how AT&T had asked people not to try to make calls in or out while they were trying to get emergency service back in service. They were talking to one of their people on the phone at the time, and in a very self-congratulatory way, they pointed out that of course they weren't using regular phones. This was a cellular phone in their car, they said without saying, of course, that the cellular phone only transmits about 3 or 4 miles until it goes into a regular telephone system. They had a lot of fun doing it nonetheless.

But I hope everybody is fine.

Mr. ISAACSON. I understand they couldn't get to my car to get my cellular phone anyway, so it didn't make any difference.

The CHAIRMAN. No matter where your car might be.

Mr. ISAACSON. That's right.

The CHAIRMAN. Let us start off with Mr. Damgard. I saw you in the audience yesterday and appreciate your being here. I would emphasize again to you and to Mr. Wilmouth, who certainly have testified on these issues over the years many, many times, what I said earlier: Feel free to add anything you wish afterward.

Mr. Damgard.

**STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES
INDUSTRY ASSOCIATION, WASHINGTON, DC**

Mr. DAMGARD. Mr. Chairman, Senator Lugar and Senator Boschwitz, my name is John Damgard, and I am here today in my capacity as president of the Futures Industry Association (FIA). I thank you very much for this opportunity to appear before you on behalf of the membership of the Futures Industry Association.

RECOMMENDATIONS AND SOME CONCERNS

You'll note from the testimony that I have submitted for the record that we support a long list of facets of the bill and are in overwhelming support of those provisions of the bill. I will devote my remarks here to some recommendations and some concerns that have been voiced by my members—which include, among others, all the domestic exchanges and many market users. Our newest members are firms like General Motors, Chrysler, AT&T, and also financial institutions such as Kemper and Aetna. Our roots, however, are really in the brokerage community, and the brokerage community, of course, is the link that the markets have to the user and to the public.

OUR INDUSTRY HAS EXPERIENCED GREAT CHANGE

Since we last met to discuss the CFTC reauthorization bill, our industry has experienced great change. We have increasingly become a global industry, and we now have serious overseas competition. A technological upheaval is rapidly changing long established ways of doing business. Recently we were victimized by some unscrupulous people who abused our system and cast a shadow over the whole industry. The challenge of this new legislation is to take these conditions into account and prepare the industry for the 21st century.

**FRAUD AND ABUSE WITHIN THE INDUSTRY MUST BE ROOTED OUT AND
STOPPED**

We all agree that fraud and abuse within the industry must be rooted out and stopped, and that every effort must be undertaken to ensure that there is the highest level of public trust in our markets.

The premise of the Commodity Exchange Act is that the exchanges will police themselves and that the CFTC will review the efficacy of these efforts. It is our belief that clearly drawn rules make for good self-regulation. We welcome such rules.

CONCERNS

We also have a number of concerns regarding the provisions of the bill which impose additional liabilities and punitive damages on futures market professionals. These provisions, in our view, may not be effective in accomplishing the committee's goals and may have unintended effects.

DUAL TRADING

As far as dual trading is concerned, the FIA has consistently taken the view that there is nothing inherently wrong with dual trading as long as the proper safeguards can be implemented to preserve the integrity of the market. The FIA therefore believes that the bill correctly links dual trading to a more precise audit trail.

AUDIT TRAIL

The FIA is committed to establishing an audit trail that accurately accounts for every trade executed on a contract market. In an effort to accomplish this objective, the bill would require that exchanges implement specific audit trail procedures consisting of three separate time stamps in addition to the time of execution. The bill also states that this time must be recorded by a "source independent of persons processing or executing" the order.

We understand that a time-stamping system implemented by an exchange and operated by FCM employees would satisfy the "independent source" requirement for customer trades, provided that the system is sufficiently accurate and tamperproof. We believe that the term "independent source" needs to be clarified.

Further, the FIA is concerned that the provisions of the bill may be overly detailed and do not adequately take into account the efficiencies and complexities of each of the different U.S. contract markets. Accordingly, Congress should consider establishing broad objectives with respect to an adequate audit trail and should require the CFTC to develop the specific standards and procedures. For example, we believe the bill should not prohibit the "flashing" of orders or the use of similar order entry methods, which may be particularly effective in certain markets but which may not meet all the requirements of the bill.

GOVERNING STRUCTURES AND CONFLICTS OF INTEREST

The committee is proposing that exchange boards be required to include meaningful representation of such interests as floor traders and brokers, brokerage firms, producers and consumers of commodities traded on the exchange, a concept which FIA has supported for many years. A related issue of concern to the FIA is diversified representation on governing boards that oversee electronic trading. For example, GLOBEX, which will be an amalgamation of partner exchanges, should have representatives from exchanges, clearing-houses, FCM's and outside directors.

We believe that certain of the terms used in the conflict of interest provision need clarification in order to assure that the amendment does not unduly restrict the ability of FCM members to participate in board deliberations.

AMENDMENT TO THE ANTIFRAUD PROVISIONS OF THE CEA

Section 4b of the CEA, the antifraud provision applicable to FCM's and other market professionals, require proof of intent before liability can attach, while section 4c, the separate antifraud provision applicable only to commodity trading advisers and com-

modity pool operators has been held not to contain such a requirement. The bill, however, would confuse this distinction by incorporating into section 4b the standard of liability established under section 4o. This amendment would therefore reverse longstanding congressional and judicial precedents under both the securities and commodities laws. We believe it should be deleted.

FCM LIABILITY FOR FLOOR TRADERS

We question the assumption in the bill that an independent floor broker is an agent of any FCM. An independent floor broker, as an independent contractor, is not within the control of any particular FCM. In addition, FCM's do not have full access to the full range of background or disciplinary information on floor brokers available to the CFTC and the exchanges, which are primarily responsible for assuring the fitness of floor brokers to handle customer orders. FCM's reasonably assume that any floor broker authorized to trade for customers is fit to do so. They rely on the CFTC and the exchanges to enforce existing registration, denial and revocation procedures and to determine when a floor broker is not fit to trade customer orders. If the committee's concern is that these existing procedures are inadequate to detect and remove unfit floor brokers, the legislation should focus instead on changes to the regulatory and self-regulatory structure.

With respect to the monitoring of floor broker executions, we understand that the committee wishes to assure that customers receive fair executions. FCM's, however, already have every incentive to provide their customers with the best executions possible. The problem is that FCM's do not have certain information that is available only to exchanges and the CFTC. Such information would include information about an independent floor broker's trades with other FCM's, which would be confidential. Moreover, imposing liability, including punitive damages, on FCM's is particularly inappropriate when the FCM itself has committed no violation and it is the responsibility of others to audit and supervise independent floor brokers.

We therefore believe that many FCM's will conclude that there is no way to protect against open-ended liability for punitive damages arising from floor broker violations and will simply cease handling customer business. Further, even those FCM's who do not go this far will be forced to restrict the extent of their customer business in order to reduce their potential exposure. This is intended neither as a threat nor as a "doom and gloom" prophecy. In order to appreciate the potential for this result, one need only observe that, while the futures markets have experienced unprecedented growth in the last 7 years, the number of FCM's handling customer business has actually declined. The bill will accelerate this trend toward reduced competition in the futures brokerage business and increase cost of trading by retail customers and commercial and institutional hedgers. We do not believe that this result is in anyone's best interest.

OTHER PROVISIONS

The FIA also supports, with minor reservations noted in our written testimony, most of the other provisions of the bill, and I'd be pleased to respond to any questions, either now or at any time in the future.

Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Damgard follows:]

TESTIMONY OF JOHN M. DAMGARD
PRESIDENT
FUTURES INDUSTRY ASSOCIATION
BEFORE THE SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY

RE: S. 1729

Mr. Chairman and members of the Committee, my name is John Damgard, and I am here today in my capacity as President of the Futures Industry Association (FIA). I thank you for this opportunity to appear before you on behalf of the membership of the FIA.

The FIA is the national trade association of the commodity futures and options trading industry. Our regular membership is comprised of more than 100 of the largest futures brokerage firms, known as "futures commission merchants" or "FCMs". They handle more than 80 percent of the transactions on U.S. futures exchanges. Our associate and international members, which number nearly 200, are a more diverse group. They include all U.S. and many foreign exchanges and clearing houses, law firms, accounting firms and users of the markets, such as commercial and investment banks and pension, insurance and mutual fund managers. Although our membership includes all facets of the futures industry, the FIA has its roots in the brokerage community, which links the futures markets with their public participants. At the FIA, our primary concern is to protect the interests of those who use and benefit from our markets.

Since we last met to discuss a CFTC reauthorization bill, our industry has experienced great change. We have increasingly become a global industry, and we now have serious overseas competition. A technological upheaval is rapidly changing long established ways of doing business. And recently, we were victimized by some unscrupulous people who abused our system and cast a shadow over the whole industry. The challenge of this new legislation is to take these conditions into account and prepare the industry for the twenty-first century.

We all agree that fraud and abuse within the industry must be rooted out and stopped, and that every effort must be undertaken to ensure that there is the highest level of public trust in our markets.

The premise of the Commodity Exchange Act is that the exchanges will police themselves and that the CFTC will review the efficacy of these efforts. It is our belief that clearly drawn rules make for good self-regulation. We welcome such rules.

As you know, FIA has long believed that a verifiable audit trail which accurately records the time of execution of each trade is an essential tool to keep our markets free from abuse and to assure that the public has confidence in them. The exchanges have made great improvements in their audit trails during the last few years. Advances in electronic systems of monitoring trades now make still more reliable audit trails possible. We therefore endorse improving the accuracy of audit trails, and we have suggestions on how to proceed to reach the goals contained in that Section of the Bill.

We also have a number of concerns regarding the provisions of the Bill which impose additional liabilities and punitive damages on futures market professionals. These provisions, in our view, may not be effective in accomplishing the Committee's goals and may have unintended adverse effects.

Audit Trail

The FIA is committed to establishing an audit trail that accurately accounts for every trade executed on a contract market. In an effort to accomplish this objective, the Bill would require that exchanges implement specific audit trail procedures consisting of three separate time stamps in addition to the time of execution. The Bill also states that the time must be recorded by a "source independent of persons processing or executing" the order.

We understand that a time-stamping system implemented by an exchange and operated by FCM employees would satisfy the "independent source" requirement for customer trades, provided that the system is sufficiently accurate and tamper-proof. We also ask that the Committee clarify that the "independent source" requirement is not mandatory, but a goal to be met, if feasible, during the statutory three-year period.

Further, the FIA is concerned that the provisions of the Bill may be overly detailed and do not adequately take into account the efficiencies and complexities of each of the different U.S. contract markets. Accordingly, Congress should establish broad objectives with respect to an adequate audit trail and should require the CFTC to develop the specific standards and procedures. For example, we believe the Bill should not prohibit the "flashing" of orders or the use of similar order entry methods, which may be particularly effective in certain markets but which may not meet the requirements of the Bill.

Governing Structures and Conflicts of Interest

We support the proposed amendments which would require self-regulatory organizations to prevent individual members with significant disciplinary records from serving on oversight or disciplinary panels and would require a sufficient diversity of membership on disciplinary committees to assure fairness and prevent special treatment. An individual who does not meet the high standards of integrity for membership on exchange boards or committees should be prohibited from serving for an appropriate period.

The Committee is also proposing that exchange boards be required to include meaningful representation of such interests as floor traders and brokers, brokerage firms, producers and consumers of commodities traded on the exchange, a concept which FIA has supported for many years. A related issue of concern to the FIA is diversified representation on exchange panels that oversee electronic trading.

We further believe that certain of the terms used in the conflict of interest provision need clarification in order to assure that the amendment does not unduly restrict the ability of FCM members to participate in board deliberations. Under the proposed provision, a member of the Board would have to recuse himself if the member or "an affiliated firm or business, a family member or any other individual with whom the member has a business or employment relationship" is, to the member's knowledge, a "specific and actual party in interest to the issue before the board." The phrase "specific and actual party in interest" is vague and subjective and should be clarified. The provision should state clearly that it applies only to parties with a separately identified interest in the issue which is different from the interests of other market participants. In addition, while the term "affiliated" firm is not defined in the Bill, we suggest that the Committee state clearly that it refers only to the firms of which the board member is an employee, officer or director, and not to the subsidiaries or related companies of that firm.

Further, the conflict provisions in the Bill would require exchange board or committee members to disclose positions in the actual contract which is the subject of board or committee consideration and which are held by the member or held "in accounts" at an affiliated firm of the member. The disclosure is required with respect to all matters before a board or committee and not just emergency actions. The inclusion of positions held "in accounts" at a member's affiliated firm could be read to include customer accounts in which the member has no direct interest. This provision could effectively prohibit representatives of major FCMs from any board or committee participation which appears to be contrary to the Committee's intent to expand board participation.

Amendment to the Antifraud Provisions of the CEA

Section 4b of the CEA, the antifraud provision applicable to FCMs and other market professionals, requires proof of intent before liability can attach, while Section 4o, the separate antifraud provision applicable only to commodity trading advisors and commodity pool operators has been held not to contain such a requirement. The Bill, however, would confuse this distinction by incorporating into Section 4b the standard of liability established under Section 4o. This amendment would therefore reverse longstanding congressional and judicial precedents under both the securities and the commodities laws. We believe it should be deleted.

The primary responsibility of a broker is the execution and clearance of transactions at the instruction of the customer, while the primary duty of an adviser is the development of trading decisions and the placement of orders with the broker, pursuant to a grant of discretionary trading authority over the customer's account. In recognition of this distinction, Congress and the courts have uniformly held advisers to a different standard of liability.

This distinction is reflected in Section 10(b) of the Securities Exchange Act of 1934 and Section 206 of the Investment Advisers Act of 1940, which are the bases for Sections 4b and 4o of the CEA, respectively. The Supreme Court has upheld on a number of occasions the different treatment of brokers and advisers under the securities laws.

Further, when Congress enacted Section 4b in 1936, and when it subsequently adopted Section 4o in 1974, it evidenced an intention to assure that the liability of brokers and advisers under the CEA would be consistent with the parallel provisions of the securities laws. In adopting Section 4o, Congress did not accept a proposal to incorporate the standards set forth in that Section into Section 4b. The amendment would therefore eviscerate a fundamental distinction in the securities and commodities laws, would subject FCMs and other registrants to a standard of liability which is inapplicable to the nature of the broker/customer relationship and would reverse 50 years of accumulated experience and precedents.

FCM Liability for Floor Brokers

Section 602 of the Bill, would make the FCM strictly liable under agency law for actual damages caused by an independent floor broker's violation as well as liable for punitive damages arising from such misconduct -- although the FCM itself did not commit the violation -- if the FCM failed to exercise due diligence in the selection or monitoring of the floor broker.

We question the assumption in the Bill that an independent floor broker is an agent of any FCM. An independent floor broker, as an independent contractor, is not within the control of any particular FCM. In addition, FCMs do not have access to the full range of background or disciplinary information on floor brokers available to the CFTC and the exchanges, which are primarily responsible for assuring the fitness of floor brokers to handle customer orders. FCMs reasonably assume that any floor broker authorized to trade for customers is fit to do so. They rely on the CFTC and the exchanges to enforce existing

registration, denial and revocation procedures and to determine when a floor broker is not fit to trade customer orders. If the Committee's concern is that these existing procedures are inadequate to detect and remove unfit floor brokers, the legislation should focus instead on changes to the regulatory and self-regulatory structure.

With respect to the monitoring of floor broker executions, we understand that the Committee wishes to assure that customers receive fair executions. FCMs, however, already have every incentive to provide their customers with the best executions possible. The problem is that FCMs do not have certain information that is available only to exchanges and the CFTC. Such information would include information about an independent floor broker's trades with other FCMs, which would be confidential. Moreover, imposing liability, including punitive damages, on FCMs is particularly inappropriate when the FCM itself has committed no violation and it is the responsibility of others to audit and supervise independent floor brokers.

We therefore believe that many FCMs will conclude that there is no way to protect against open-ended liability for punitive damages arising from floor broker violations and will simply cease handling customer business. Further, even those FCMs who do not go this far will be forced to restrict the extent of their customer business in order to reduce their potential exposure. This is intended neither as a threat nor as a "doom and gloom" prophecy. In order to appreciate the potential for this result, one need only observe that, while the futures markets have experienced unprecedented growth in the last seven years, the number of FCMs handling customer business has actually declined. The Bill will accelerate this trend toward reduced competition in the futures brokerage business and increased cost of trading by retail customers and commercial and institutional hedgers. We do not believe that this result is in anyone's best interest.

Treatment of All Violations of the CEA as Felonies

Section 608 of the Bill would add a new Section 9(h) to the CEA, which would make any violation of the statute or CFTC regulations a felony punishable by a fine of up to \$500,000 and/or imprisonment of up to 5 years. To the best of our knowledge, however, no one -- including the United States Department of Justice -- has suggested that the CEA as currently constructed is in any way deficient or that the statute does not provide for sufficient criminal penalties. We therefore question the need for the amendment.

In addition, the existing criminal provisions of Section 9 of the CEA, which provide for misdemeanors as well as felonies, have been carefully constructed and modified over the last 50 years and would not be repealed under the Bill. The addition of Section 9(h) throws the continued viability of these provisions into question and raises issues regarding congressional intent. Moreover, many of the CFTC's regulations are technical and should not be the basis of criminal liability.

Punitive Damages

We understand that Section 603 of the Bill, which provides for punitive damages in exchange and NFA arbitrations, CFTC reparations and private court litigation, is intended only to apply to violations of law by floor brokers or in connection with conduct that occurs on exchange floors. The language of the Section, however, does not make this clear, and the reference to the "making of a trade" could be read to include all conduct related to a trade. We therefore ask that this provision be clarified.

In addition, unlike other trading contexts, the amount of a futures customer's loss generally far exceeds whatever commission revenue the broker receives. As a result, a judgement against an FCM requiring it to pay the customer the amount of any losses provides a sufficient incentive to guard against misconduct. A person acting in violation of the CEA may also be subject to CFTC, NFA and/or exchange sanctions, which would be increased under the Bill and which could include criminal sanctions. The imposition of punitive damages on FCMs is therefore unwarranted.

Dual Trading

The FIA has consistently taken the view that there is nothing inherently wrong with dual trading, as long as the proper safeguards can be implemented to preserve the integrity of the market. The FIA therefore believes that the Bill correctly links dual trading to a more precise audit trail.

CFTC Oversight of Exchanges

The FIA generally supports CFTC oversight of exchange systems, audit trails and other floor oversight and compliance efforts. In the last 15 years, the authority to initiate rule reviews has served the CFTC well as a means of identifying areas where improvements were needed. We believe that allowing the CFTC to issue deficiency orders will be effective in strengthening its oversight powers. Our concern in this area is that the schedule of fines and penalties, which in some cases may be as high as \$500,000 per day per violation, may be excessive.

Service Fees

The drafters of the Bill have indicated that it authorizes the CFTC to impose service fees in order to help fund the additional cost of monitoring trading floors and assuring compliance by exchanges with the requirements of the Bill. The CFTC would therefore not be authorized to fund its entire budget in this manner, and the Bill should be clarified in this respect. In addition, market professionals are presently subject to a significant number of fees in connection with their trading activities, all of which, in some form, are ultimately borne by the market user. The imposition of a service fee will in effect operate as an additional tax on market users, the group the Committee has stated it seeks to protect. We believe these considerations should be borne in mind by the Committee in structuring the service fee provisions.

Broker Associations

The FIA has previously supported the registration of broker groups, and we are in favor of the CFTC's current efforts to review issues arising in this area in order to propose any necessary regulations. We welcome the provision in the Bill which would have the CFTC adopt regulations and establish procedures. To avoid unintended consequences we recommend that the effective date of the Bill's ban on broker associations be delayed until the CFTC's regulations are in place.

We are concerned that the language of the Bill may be construed to sweep within this prohibition any trading between employees of the same FCM. The fact that two individuals are employed by the same FCM, standing alone, has never been sufficient to encompass such individuals within the definition of a broker associations. Unless the employees operate under some sort of agreement or understanding between themselves, we can perceive no reason why they should be subject to the prohibition.

Other Provisions

The FIA also supports, with the minor reservations noted, the following provisions:

- The five year authorization for the CFTC;
- The enhancement of the hiring and compensation authority of the CFTC;
- The establishment of standards and procedures for oral orders by the CFTC (which, in the view of the FIA, should accommodate spread trading) with the understanding that CFTC regulation is in lieu of banning such orders;
- The registration of floor traders;
- A study of penalties assessed by exchanges for trade practice violations;
- The provision permitting the NFA to appeal CFTC orders;
- The proposal to require exchanges to include on disciplinary committees qualified persons representing segments of the exchange membership other than that which is the subject of the proceeding and, where appropriate, qualified non-members; and
- The provision regarding exchange notification of customers with respect to actions against floor brokers, provided that the role of the FCMs with respect to such notification is clarified.

The FIA also endorses the following CFTC, NFA or House proposals included in the Bill:

- The "Telemarketing Fraud" provision;
- The amendment which grants the CFTC more latitude in determining the amount of civil monetary penalties and provides for automatic suspension of registration and a trading prohibition upon a failure to pay a civil monetary penalty;
- The authorization of nationwide service of process in private actions filed in Federal court based on violations of the CEA;
- The sections permitting the CFTC to engage in cooperative enforcement efforts with foreign futures authorities;
- The requirement that futures industry professionals attend periodic ethics training sessions;
- The mandated GAO study of delivery points in agricultural futures markets; and
- The tightening of NFA registration standards.

However, the specific language of all of S. 1729 warrants closer review than was possible during the time we were given to prepare this testimony. Therefore, we ask the Committee's permission to submit additional comments and suggestions for the record.

The CHAIRMAN. Our next witness is Mr. Isaacson.

STATEMENT OF ROBERT L. ISAACSON, PRINCIPAL, COMMODITY INVESTMENT CONSULTANTS, REPRESENTING THE NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, SAN FRANCISCO, CA

Mr. ISAACSON. Good morning, Mr. Chairman, and members of the committee.

INTRODUCTION

I am Robert Isaacson, an Independent Commodity Trading Advisor from San Francisco, California. I am here today as vice president of the National Association of Futures Trading Advisors, known as NAFTA. NAFTA is a national trade association of approximately 150 firms and individuals who manage almost \$6 billion in investments for their clients. Our members are Commodity Trading Advisors (CTA) and Commodity Pool Operators (CPO). They operate and/or advise a substantial number of the commodity pools and managed futures accounts currently in existence.

WE FEEL INVESTOR CONFIDENCE IN THE U.S. FUTURES MARKETS IS ESSENTIAL TO THE CONTINUED VITALITY AND GROWTH OF OUR INDUSTRY

Managed accounts and commodity pools provide an increasingly popular alternative to direct speculative trading by individual investors. Accordingly, NAFTA's members are substantial users of the exchanges on behalf of their customers. Mr. Chairman, we feel investor confidence in the U.S. futures markets is essential to the continued vitality and growth of our industry.

For all these reasons, and in order to be more closely in touch with the regulatory and legislative process, NAFTA has within the past year moved its headquarters to Washington, DC. We have hired a man with outstanding credentials and well-known to this committee as our executive director, former CFTC Commissioner Bill Seale. Furthermore, in addition to our regular general counsel in Chicago, we have also retained Terry Claassen as special counsel here in Washington to assist NAFTA with regulatory and legislative policy matters.

VIEWS ON SEVERAL OF THE ISSUES RAISED IN S. 1729

Therefore, NAFTA particularly welcomes this opportunity to share with the committee the experience of its members under the current regulatory framework and to provide views on several of the issues raised in S. 1729.

NAFTA ENTHUSIASTICALLY SUPPORTS ANY MOVE AWAY FROM REGULARLY SCHEDULED COMPLETE OVERHAULS OF THE CFTC'S LEGISLATIVE AUTHORIZATION

First, Mr. Chairman, NAFTA enthusiastically supports any move away from regularly scheduled complete overhauls of the CFTC's legislative authorization. We believe the periodic reauthorization process drains substantial CFTC staff resources and thereby detracts from the agency's ability to perform its regulatory functions.

**NAFTA SUPPORTS THE BILL'S STRONG EMPHASIS ON ENHANCED
EXCHANGE AUDIT TRAILS**

Regarding specific provisions of S. 1729, NAFTA supports the bill's strong emphasis on enhanced exchange audit trails. As I said earlier, public confidence in U.S. markets is essential. At the same time, however, NAFTA members are concerned by the suggestions of some that the standards which would become effective 3 years after enactment are intended to force all futures trading into computers. We believe it is critical for the market, not the government, to decide when, if ever, computerized trading may be better than the traditional open outcry markets. It would be easy to feed orders into a computer and have it spit back executions just as it could be arranged to have a computer cast votes in the Senate on the basis of reliable public opinion polls back home. But the market and the Senate would both lose the essential human dynamics which make them effective—imperfect perhaps, but effective.

**NAFTA DOES NOT BELIEVE A PROHIBITION OF DUAL TRADING IS
APPROPRIATE OR NECESSARY AT THIS TIME**

On another important issue, NAFTA does not believe a prohibition of dual trading is appropriate or necessary at this time.

NAFTA believes dual trading should be allowed to continue, subject to disclosure to customers that a broker intends to trade for his own account. Existing CFTC regulations require just such disclosure to prospective customers of Commodity Trading Advisors and Commodity Pool Operators. This disclosure would allow a customer to choose for himself without the market having to suffer the costs we have talked about earlier.

Accordingly, NAFTA favors the approach contained in S. 1729. It would permit the continuation of this important practice at each exchange, as long as the CFTC remains satisfied that the exchange's surveillance system effectively deters and detects dual trading abuses.

**NAFTA HAS LONG SUPPORTED THE DEVELOPMENT OF ETHICAL
STANDARDS THROUGHOUT THE FUTURES INDUSTRY**

NAFTA has long supported the development of ethical standards throughout the futures industry. In fact, NAFTA views as one of its purposes the enhancement of ethical standards for trading advisors and pool operators and intends to include sessions in this area in its future annual meetings.

Our segment of the futures industry is subject to a broad array of regulations. Commodity Trading Advisors, Commodity Pool Operators, and their associated persons are required to register with the NFA. Each of these associated persons must first successfully pass the National Commodity Futures Examination. The NFA conducts regular audits of all NAFTA members. Exhaustive disclosure, recordkeeping and reporting regulations govern Commodity Trading Advisors and pool operators, and pool operators must also provide annual audited financial statements to their customers, the NFA and the CFTC.

Comprehensive securities regulations also govern pool operators and trading advisors.

NAFTA members are thus subject to a broad range of compliance responsibilities. This regulatory framework is considerably broader in scope than that applicable to almost any other CFTC registrants.

**MORE VIGOROUS ENFORCEMENT OF EXISTING FUTURES INDUSTRY
REGULATIONS**

All of this leads NAFTA members to believe more vigorous enforcement of existing futures industry regulations may be more effective in preventing abuses than another regulatory layer of "ethics" training. Nevertheless, NAFTA commits our full assistance to the CFTC for the purpose of crafting such regulations. In fact, NAFTA would undertake to provide any such required training for its members and would encourage Congress to suggest such an approach for members of NAFTA and other similar trade organizations.

Mr. Chairman, we appreciate the opportunity to present our views, and I will be happy to answer any questions.

[The prepared statement of Mr. Isaacson follows:]

Statement of Mr. Robert L. Isaacson
on behalf of the
National Association of Futures Trading Advisors

Before the
Committee on Agriculture, Nutrition, and Forestry
United States Senate

Tuesday, October 17, 1989

Good afternoon Mr. Chairman and members of the Committee. I am Robert L. Isaacson, an independent Commodity Trading Advisor from San Francisco, California. I am here today as Vice President of the National Association of Futures Trading Advisors, known as NAFTA. NAFTA is a national trade association of approximately 150 firms and individuals who manage almost \$6 billion in investments for their clients. Our members are Commodity Trading Advisors (CTA) and Commodity Pool Operators (CPO). They operate and/or advise a substantial number of the commodity pools and managed futures accounts currently in existence.

Managed accounts and commodity pools provide an increasingly popular alternative to direct speculative trading by individual investors. Accordingly, NAFTA's members are substantial users of the exchanges on behalf of their customers. Mr. Chairman, we feel investor confidence in the U.S. futures markets is essential to the continued vitality and growth of our industry.

For all these reasons, and in order to be more closely in touch with the regulatory and legislative process, NAFTA has within the past year moved its headquarters to Washington, D.C. We have hired a man with outstanding credentials and well-known to this Committee as our Executive Director, former CFTC Commissioner Bill Seale. Further, in addition to our regular general counsel in Chicago, we have also retained Terry Claassen as special counsel here in Washington to assist NAFTA with regulatory and legislative policy matters. Our Association is committed to actively assisting both the Congress and the CFTC in developing and carrying out a fair and effective regulatory system.

Therefore, NAFTA particularly welcomes this opportunity to share with the Committee the experience of its members under the current regulatory framework and to provide views on several of the issues raised in S. 1729.

First, Mr. Chairman, NAFTA enthusiastically supports any move away from regularly scheduled complete overhauls of the CFTC's legislative authorization. We believe the periodic reauthorization process drains substantial CFTC staff resources and thereby detracts from the agency's ability to perform its regulatory functions. The benefits of the reauthorization process could, in our opinion, be achieved more efficiently through periodic oversight hearings. In addition, of course, the ability of Congress to conduct investigations and hearings on specific topics of public importance, such as the recent investigation of futures trading practices, would not be impaired.

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NAFTA members occupy a unique niche in the futures industry. Our members organize and operate commodity pools, and manage both pool and individual accounts. Commodity pools resemble investment companies, with the services rendered by Commodity Trading Advisors substantially resembling those of investment advisors in the securities industry. To the extent practicable, similar regulatory frameworks should apply both to Commodity Trading Advisors and investment advisors, and also to Commodity Pool Operators and investment companies. Consistent regulatory obligations would ensure neither set of investment managers receives a competitive advantage as a result of disparities in the manner in which they are regulated.

This issue is particularly acute for NAFTA's members in the area of publicly offered commodity pools. These pools trade in futures contracts and are, therefore, subject to CFTC jurisdiction. They are typically offered in the form of limited partnerships, however. Therefore, the SEC and state securities agencies also regulate pools, since the limited partnership interest constitutes a security. Consequently, a publicly offered commodity pool must satisfy the regulations of the CFTC, SEC and of the states in which the particular offering is to be made.

One highly unfortunate result of multiple regulation has been a steady increase in the size of prospectuses for publicly offered funds and subsequent corresponding increases in the costs of organizing such funds. NAFTA's members believe that the length and complexity of disclosure is now so great that, in some cases, investors are literally overwhelmed with information. This completely defeats the very purpose of disclosure. For these reasons, NAFTA supports and commends the recent increase in communication between the financial market regulators, as evidenced by recent companion releases on the subject of disclosures related to publicly offered commodity pools.

NAFTA urges both the CFTC and SEC, for example, to explore the possibility of a two part prospectus requirement for publicly offered commodity pools in the manner currently permitted by the SEC for investment companies. NAFTA believes a simplified prospectus could make disclosures to prospective commodity pool investors more meaningful, while a more detailed supporting prospectus (comparable to what is now required to be provided to all investors) could be made available on request to those investors who desire additional information.

NAFTA notes this is not an area addressed by S. 1729. Given the bill's emphasis on enhanced customer protection and marketplace integrity, however, we respectfully urge the Committee to address this issue. Streamlined, simplified, usable disclosure requirements for commodity pools would substantially enhance public commodity customer awareness.

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Another area of particular concern to NAFTA's members is that of speculative position limits and aggregation policies. These policies were initially promulgated prior to the development of a managed money sector in the futures industry. And they have not been reconsidered for their impact in inhibiting the development of the managed money products. NAFTA is aware several large and extremely successful commodity trading advisors have increasingly turned to allocating funds to foreign markets in order to avoid restrictions imposed by speculative position limits which apply to U.S. markets but not to foreign markets. As capital leaves U.S. markets to less regulated foreign markets the consequences for the public and for the futures industry itself become increasingly negative. Potential investors could be harmed because foreign markets typically have substantially fewer customer safeguards. While no one believes U.S. markets should compete with foreign markets by eliminating what are widely recognized to be valuable customer protection measures, NAFTA believes speculative position limits and aggregation policies should be reviewed thoroughly for their continued efficacy. NAFTA requests Congress to encourage the CFTC to continue the work it began in this area when it recently modified some of its rules pertaining to aggregation.

Turning to specific provisions of S. 1729, NAFTA supports the bill's strong emphasis on enhanced exchange audit trails. As I said earlier, public confidence in U.S. markets is essential. At the same time, however, NAFTA members are concerned by the suggestions of some that the standards which would become effective three years after enactment are intended to force all futures trading into computers. We believe it is critical for the market, not the government, to decide when, if ever, computerized trading may be better than the traditional open outcry markets.

Just like the people of Vermont, or Indiana, or all of the other States elect Senators to come to the Congress to use their best judgment in representing them, so do investment managers select brokers. It would be easy to feed orders into a computer and have it spit back executions, just as it could be arranged to have a computer cast votes in the Senate on the basis of reliable public opinion polls back home. But the market and the Senate would both lose the essential human dynamic which makes them effective -- imperfect perhaps, but effective.

On another important issue, NAFTA does not believe a prohibition of dual trading is appropriate or necessary at this time. While NAFTA appreciates that unspecified alleged abuses have prompted the proposals to prohibit dual trading, we believe substantial and valid reasons call for better remedial steps. First, the proposal would have several negative consequences:

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(1) Many of the most skillful brokers may choose to trade entirely for themselves and no longer for customers. Because many money managers execute large orders for their clients, quality execution of trades is particularly important. Many NAFTA members devote substantial attention to reviewing the quality of order fills and selecting the brokers with whom they place orders. If a ban on dual trading were to convert brokers into traders, the ability of our members to trade profitably for their customers would be hampered.

(2) Such a ban would reduce the liquidity of the markets. In some cases, this would make it more difficult to enter and to exit positions for customers; and

(3) If for any reason volume were to decrease significantly, a dual trading ban would result in increases in brokerage commission rates.

NAFTA believes dual trading should be allowed to continue, subject to disclosure to customers that a broker intends to trade for his own account. Existing CFTC regulations require just such disclosure to prospective customers of Commodity Trading Advisors and Commodity Pool Operators. This disclosure would allow a customer to choose for himself without the market having to suffer the costs I have just described.

Furthermore, we believe increased surveillance by the exchanges and by the CFTC, along with technological developments enhancing the quality of audit trails, should make all trade practice abuses increasingly rare.

Accordingly, NAFTA favors the approach contained in S. 1729. It would permit the continuation of this important practice at each exchange, as long as the CFTC remains satisfied that that exchange's surveillance system effectively deters and detects dual trading abuses.

S. 1729 would require exchange and other self-regulatory organization governing boards to include at least 20 percent "non-member" directors. NAFTA supports the concept of outside directors on governing boards as a general principle. In fact, the NAFTA board of directors includes an outside director, even though we are a private trade association. However, NAFTA believes no particular merit exists in a fixed 20 percent requirement. NAFTA believes the experience and knowledge of individual governing board members, whether member or non-member, are more critical to sound decision-making and representation of public interests than mandated percentages.

S. 1729 would impose a three-day "cooling off" period between the time an account is opened for a first-time speculative customer who was solicited by telephone and the day on which this customer may make his first trade. First, I would point out that telemarketing is not used to any significant

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degree by NAFTA members. Nevertheless, in the interests of enhanced investor confidence in our markets, we support the concept of such a cooling-off period. NAFTA members are concerned, however, that it would be extremely difficult to implement and police the proposal contained in S. 1729. For example, it is not clear to what extent a brokerage firm could rely upon oral assurances from the customer that he was not a first-time customer. What types of evidence would suffice to permit a broker to satisfy this question?

Finally, NAFTA has long supported the development of ethical standards throughout the futures industry. In fact, NAFTA views as one of its purposes the enhancement of ethical standards for trading advisors and pool operators and intends to include sessions in this area in its future annual meetings.

Our segment of the futures industry is subject to a broad array of regulation. Commodity Trading Advisors, Commodity Pool Operators, and their associated persons are required to register with the NFA. Each of these associated persons must first successfully pass the National Commodity Futures Examination. The NFA conducts regular audits of all NAFTA members. Exhaustive disclosure, recordkeeping and reporting regulations govern Commodity Trading Advisors and pool operators, and pool operators must provide annual audited financial statements to their customers, the NFA and the CFTC.

These regulations have been in place for over a decade, and continue to be supplemented from time to time by NFA compliance rules covering areas such as promotional materials. NFA staff also conduct periodic compliance audits. Comprehensive securities regulations also govern pool operators and trading advisors.

NAFTA members are thus subject to a very broad range of compliance responsibilities. This regulatory framework is considerably broader in scope than that applicable to almost any other CFTC registrants.

All of this leads NAFTA members to believe more vigorous enforcement of existing futures industry regulations may be more effective in preventing abuses than another regulatory layer of "ethics" training. This is in large part due to NAFTA's concern that serious problems must be very carefully considered in developing any regulations to implement such a requirement. Would this requirement create a financial hardship on individuals and smaller firms, for example, by imposing travel to central locations for initial or refresher training sessions? For these kinds of reasons, NAFTA urges extreme care in crafting any regulations and we commit our full assistance to the CFTC for that purpose. In fact, NAFTA would undertake to provide any such required training for its members and would encourage Congress to suggest such an approach for members of NAFTA and other similar trade associations.

Mr. Chairman, we appreciate the opportunity to present the views of our Association. I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much.
 Mr. Lind, we will go to you next. That way Bob Wilmouth gets the last word, as he usually does anyway.
 Mr. Lind.

STATEMENT OF BARRY J. LIND, CHAIRMAN, LIND-WALDOCK &
 CO., CHICAGO, IL

Mr. LIND. That seems to be the way it always works.

INTRODUCTION

Good morning, Mr. Chairman, Senator Lugar, Senator Boschwitz. Thank you for the opportunity to speak before you today.

My name is Barry Lind, and I am the chairman of Lind-Waldock & Company.

I am here today on behalf of my company as well as on behalf of our over 12,000 active customers, who represent a considerable cross-section of the investing public.

We fill approximately three-quarters of a million customer orders per year. We employ over 500 people and rank as the Nation's largest discount futures broker.

But I am not just representing Lind-Waldock's customers—I am representing the FCM community as well. That is as it should be. The customers' interests and the FCM's interests are one and the same.

As a futures commission merchant, as a spokesperson for the individual investor in the futures market, or as a clearing member of seven U.S. futures exchanges, I have but one objective. And it is the same objective that everyone in this room shares. It is our obligation to represent and to protect the interests of the investing public.

I have prepared more expansive remarks covering a broader range of issues for inclusion in the record. I will address my remarks here to the most significant features of the bill as I see them.

AUDIT TRAIL

In regard to audit trail, we support increased audit trail capability. We agree with the committee's goal of setting overall standards of performance. But we take issue with the explicit direction contained in the bill.

A vastly improved audit trail system is already being developed by the people best-equipped to do this—the exchanges. I speak from personal experience on this issue since I have been closely involved with the Chicago Mercantile Exchange's effort to develop such a system.

This system will allow us as FCM's to determine far more precisely when the broker got the order and when he executed the order. By narrowing the window of uncertainty, this system will meet or exceed the committee's objectives, it will meet our objectives, and it will meet the customers' objectives—and it will do so without disruptive the speed and liquidity that are so vital to the efficient functioning of the futures market.

BROKER ASSOCIATIONS

The section of the bill that deals with broker associations, I feel is based on the erroneous assumption that such associations are uniformly and unfailingly detrimental to the public interest. We do not agree. Broker associations play a necessary, legitimate and valuable role in the prompt filling of customer orders. Yes, there is greater potential for abuse, but this remedy is inappropriate. There is nothing wrong with two members of a broker association, where each one is filling a customer's order, doing that transaction with each other. There is no gain to anyone except the customer. And if that activity is going to be banned, my customers are going to suffer.

Even a benign interpretation of the bill threatens to interfere with getting a customer's order filled at the best price in an open outcry market. Competition will be reduced.

If the CFTC fails to come up with an acceptable standard, the enactment of this proposed legislation would have serious negative consequences for the public investor.

LIABILITY OF FCM'S

The section of the bill dealing with FCM accountability and liability issues is the most troubling to us. We do not suggest for a moment that we are not responsible to our customers to get their orders filled fairly and fast. We are absolutely responsible for just that, and we have systems in place to ensure that that occurs. We will fight for our customers even over one tick, and we do that every day.

Yes, I am responsible for the order that should have been filled but does not get filled. That is my duty as an FCM. But I am not responsible for the guy who hears an 80 bid and says to the local next to him "sell that" and then fills my order with that local at 78. I cannot be responsible for that because I cannot police that.

Consider for a moment the unreasonable standard that this bill would impose on FCM's. At Lind-Waldock, we fill over 3,000 customer orders every day. In any given month, we use over 700 independent floor brokers on 7 futures exchanges nationwide. It would be impossible for us to oversee the minute-to-minute activities of those hundreds of brokers. Even if we could, the costs of doing so would probably put us out of business.

In a matter of seconds, a market may trade at three or four different prices. A fill within that range may be legitimate; it may not be legitimate. Mr. Chairman, members of the committee, I have to tell you, short of standing in the pit beside my undercover agent, I have no way of detecting that irregularity. Yet, this provision would put my firm in a position of unlimited liability for actions that we have no reasonable ability to monitor or control.

I believe that one of the statements that did not clearly come out yesterday afternoon was that the procedure and remedy exists today at the exchanges for the customer against the floor broker regarding dishonest acts that the FCM doesn't cover, and that has been used far more often recently than it had been used before—I am going back to last year—and the customer has been recompensed.

CONCLUSION

In conclusion, the integrity of our markets is a critical concern for all of us. A close examination of our rules and standards is healthy.

But in all our efforts to examine, review, and amend, let us not lose sight of the fact that our markets are setting the standard for the world. The liquidity, efficiency and effectiveness of these markets is copied from London to Singapore, from Paris to Tokyo.

Despite recent highly publicized allegations, and the illumination of weakness, there is little to suggest that the system has failed. I caution the committee to weigh each proposed change very carefully against the possibility that it could impede the smooth functioning of this essential economic institution.

Mr. Chairman, Senators, I thank you for the opportunity to address you today. I'd be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Lind. We'll hold the questions until we've heard from Mr. Wilmouth, who now will put this all in perspective.

[The prepared statement and attachments of Mr. Lind follow:]

TESTIMONY
OF
BARRY J. LIND
CHAIRMAN OF LIND-WALDOCK & COMPANY
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
OCTOBER 17, 1989

INTRODUCTION

Mr. Chairman, Members of the Committee, thank you for this opportunity to speak before you today. My name is Barry Lind, and I am the Chairman and Chief Executive Officer of Lind-Waldock and Company. I am a Board member of the National Futures Association and have been since its inception.

I am here today on behalf of my company as well as on behalf of our 12,000 active customers, who come from every state in the Union and most countries in Western Europe. As such, they represent a considerable cross-section of what we know as the public investor. In addition, Lind-Waldock customers, on average, have accounts of \$10,000 or less -- another element of the "public investor" profile.

We fill approximately three quarters of a million orders per year for our customers. We employ over 500 people. Our firm has been serving the individual investor for 24 years. We have done it well enough to have achieved a position as the nation's largest futures discount firm, with over a 60% market share.

But I am not just representing Lind-Waldock's customers -- I am representing the FCM community as well. That is as it should be. The customers' interests and the FCM's interests are one and the same. The FCM who does not put his customer's interests foremost will not be in business very long.

As a futures commission merchant, as a spokesperson for the individual investor in the futures market, or as a clearing member of seven U.S. futures exchanges -- I have but one objective. And it is the same objective that everyone in this room shares. It is our obligation to represent and to protect the interests of the investing public. We know that without the confidence of the public, our markets will not survive.

AUDIT TRAIL

We support the Committee's efforts to improve audit trail capabilities. For us, as for all FCMs, our efforts to determine the accuracy of customer fills are impeded by the "window", or gap between the time when the order reaches the floor and the time it is executed. The window, generally about two minutes, can range up to three and one half minutes which makes it difficult for the FCM to determine with a high degree of certainty that an order was filled fairly and accurately.

I would like to mention in this regard that we at Lind-Waldock monitor our brokers and the fills our customers receive on their orders very carefully. Our recent customer survey, a copy of which is attached, indicates that in cases where a customer is not satisfied with a fill and reports this to our firm . . . in thirty seven percent of these cases, we are already looking into the

situation. No broker keeps a Lind-Waldock deck if any irregularities regarding fills are suspected.

We are very encouraged by the fact that the Exchanges have audit trail systems in development that would allow us to narrow the "window" and thereby monitor fills more accurately. I speak from experience on this issue, since I have been closely involved with the Chicago Mercantile Exchange's efforts to develop an improved audit trail system.

The system will be operational well within a three year period of time. Once implemented, the Chicago Mercantile Exchange system could reduce the window to as few as twenty seconds -- more than meeting the committee's broad objective of one minute. In our opinion, that will do a great deal to enhance the confidence that our customers have in the timeliness and integrity of the order-filling process. In this regard, while we do not dispute the Committee's valuable role in setting overall standards for an audit trail, we are confident that the means by which those standards are met is properly the responsibility of the Exchanges.

It is critically important, however, to make a distinction between "paper" orders and "flash" orders because the two present quite different requirements with regard to audit trail. With a paper order a phone clerk writes down the customer order and a runner takes it to the broker in the trading pit. That is the process that most people associate with activity on the trading floor.

In an effort to provide customers with the quickest response possible, however, many orders are now taken as "flash" orders or "arb" orders. With an arbed order, the order clerk signals or shouts to a broker in the pit the terms of the order. The order is filled virtually instantaneously. At Lind-Waldock, for example, we often take the customer's order by phone and report back a fill in the same conversation.

Because of the speed at which flash orders are filled, they present few problems in terms of audit trail. The time stamp is likely to show the same minute for order entry and order fill. And because a second or a few seconds can be critical in a fast-moving market, we are not in favor of a system that would require additional time-stamping. To implement such a system, we believe, would impact our customers and the futures markets negatively by reducing the speed and liquidity that are well-established advantages of the futures markets.

THREE-DAY RULE

In our 24 years in business, we have distanced ourselves as far as possible from the types of firms that utilize sales practices that the three-day rule is designed to prohibit. But because we are part of the FCM community, we cannot distance ourselves far enough. There should be no room in our industry for any firm engaging in high-pressure, boiler-room-type operations.

In terms of concentrating resources and manpower in an area where they are likely to benefit the investing public the most, I put to you that more investors' money has been lost through deceptive sales practices than through other areas that have been more highly publicized this past year.

Our only quarrel with this provision of the Bill is that it does not go far enough. In a recent case, for example, it took five years to put a particularly flagrant violator out of business. Once a serious abuse is detected, we must have the systems and regulations in place to stop it quickly. The three-day rule is an important initial step toward eliminating deceptive sales practices.

BROKER ASSOCIATIONS

The provision of the Bill which imposes a total ban on the trading in broker associations unless the CFTC develops procedures and standards designed to prevent violations will clearly impact the way we do business to the detriment of our customers. The total prohibition and its alternative must be redrafted to allow trading among members of a broker association when both are filling customer orders.

Broker associations serve a valuable purpose. Our firm has used groups of brokers from its inception. Only recently have Exchanges required that these groups disclose themselves and register their group. Our firm uses broker associations in a majority of markets, as do most FCM's. We exercise great care in the selection of the broker associations that we use to fill our customer orders. We place confidence in the fact that these broker associations are also very diligent in their selection of which floor brokers may be associated with them. If Lind-Waldock traded for its own account, we would place those orders with broker associations also.

One of the reasons for using a broker association over an independent floor broker is that we know that there will be someone there to assist the broker in handling the flow of orders. I can tell you that I do not know any FCM who, under any circumstances, would give the responsibility of filling customer orders to an incompetent broker or someone they know to be dishonest.

When a member of a broker association fills a customer order against a customer order executed by another member of the broker association there is virtually no opportunity for fraudulent activity. The greater potential for violations of the Act arising from trading among members of a broker association occurs when one member trades his personal account opposite an order executed by another member of the association. However, the Bill goes even further than that. This can best be illustrated by an example:

Floor Broker "A" and Floor Broker "B" are members of a broker association which fills orders in a busy market

such as the S&P at the Chicago Mercantile Exchange. The market is trading at 50 bid and 55 offer. "A" receives a customer order to buy at the market. "B" offers 55 for a customer order that he is filling. Under the present rules, "A" could buy "B's" offer at 55 and the fills would be on their way back to the customers. However, the proposed regulation would prohibit such a trade. "A" now bids 55. A third party not in the association buys "B's" 55 offer and offers at 60 which "A" is now obligated to buy. The net result is that the customer's market order is filled at 60 instead of 55.

Clearly, when floor brokers are not totally restricted from trading with someone participating in the open outcry system of the market the price of execution of an order remains competitive and fair. The current percentage rules for trading among members of broker associations implemented by the Chicago Mercantile Exchange limits the floor-broker to local transactions. They also limit, but not ban, floor broker to floor broker executions when two customer orders are involved. The orders are filled and aside from floor brokerage fees for executing the order, the floor brokers have no financial interest or derive any benefit from the transaction. These percentage restrictions allow the system to continue working and do not penalize the customer if the best bid or offer in the market happens to be from another member of the broker association.

The procedures designed by the CFTC must be flexible to permit a limited percentage of trades among members of a broker association. However, the requirement that the Commission certify that their procedures and standards will prevent violations of the Act attributable to trading of this nature places too stringent a standard on the Commission. Their only alternative is to develop a regulation that will place an equally burdensome restriction on competition and efficient execution of customer orders.

LIABILITY OF FCMs

The section of the bill dealing with FCM accountability and liability issues is the most troubling to us. We do not suggest for a moment that we are not responsible to our customers to get their orders filled fairly and fast. We are absolutely responsible for just that, and we have systems in place to ensure that it occurs. We will fight for our customers even over one tick, and we do that every day.

Yes, I am responsible for the order that should have been filled but does not get filled. That is my duty as an FCM. But I am not responsible for a guy who hears an 80 bid and says to the local next to him "sell that" and then fills my order at 78. I cannot be responsible for that because I cannot police that.

Consider for a moment the unreasonable standard that this bill would impose on FCMs. At Lind-Waldock, we fill over 3000 customer orders every day. In a given month, we use over 700 independent floor

brokers on seven futures Exchanges nationwide. It would be impossible for us to oversee the minute-to-minute activities of those hundreds of brokers. Even if we could, the costs of doing so would probably put us out of business.

In a matter of a second, a market may trade at three different prices. A fill within that range may be legitimate or questionable. Mr. Chairman, members of the Committee, short of standing in the pit beside my undercover agent . . . I have no way of detecting that irregularity. Yet, by making the FCM a principal of everyone who fills orders for us, we are put in the position of unlimited liability for the actions that we have no reasonable ability to monitor. As a business, we must anticipate our costs and recover them. We simply could not continue to operate in such an environment.

Everyone in this room knows about the recent indictments concerning T-Bond transactions where our customers were named. Let me point out that the only way in which that activity could be uncovered was apparently as a result of a collusive activity with someone who turned out to be an agent of the Federal Bureau of Investigation. I think you would agree that it is not a practical solution for brokerage firms to include teams of undercover agents on their payrolls. I think you would agree that imposing such an unreasonably stringent standard on FCMs is grossly unfair and damaging to our customers.

Certainly, the responsibility for monitoring trading practices is a joint one: the Exchanges, the FCMs, the Exchange members, and the regulatory agencies all share in it. But the liability for malfeasance properly rests with the independent floor broker, thereby giving customers a remedy. In turn, the broker's exchange membership serves as his or her guarantee. This is a workable system.

Procedures and remedies exist at the Exchange level for the customer against the floor broker for dishonest acts that the FCM does not cover. I assure you, this provision as it is presently drafted will serve only to victimize our customers in amounts greater than those allegedly uncovered by the Federal Bureau of Investigation and the United States Attorney.

CONCLUSION

In conclusion, I think I can speak for all of us when I say that we are in agreement with the spirit of the Committee's efforts. The integrity of our markets is a critical concern for all of us. Closely examining our rules and standards is healthy.

But in all our efforts to examine, review, and amend, let us not lose sight of the fact that our markets are setting the standard for the world. The liquidity, efficiency, and effectiveness of these markets is copied from London to Singapore, from Paris to Tokyo.

Despite recent highly publicized allegations and the illumination of weakness, there is little to suggest that the system failed. And I caution the committee and the industry to weigh each proposed change very carefully against the possibility that such a change could impede the smooth functioning of this essential economic institution.

C14 THE WALL STREET JOURNAL WEDNESDAY, AUGUST 9, 1989

AN OPEN LETTER TO LIND-WALDOCK CUSTOMERS

WHAT HAPPENED

A federal grand jury has indicted 46 independent commodity traders and brokers in its investigation of trading practices at the Board of Trade and the Mercantile Exchange. (There are over 6200 members on the two exchanges.) The allegations state that trading rules were violated, that fraud was committed and that some customer orders (including ours) were improperly handled. Be assured that neither Lind-Waldock nor any of its employees have been indicted, and we expect that none will.



Barry Lind, Chairman Lind-Waldock

WHERE WE STAND

We support any investigation into misconduct in the industry. Our interests and those of our customers are, and always have been, inseparable. We have always vigorously pursued customer complaints, and we always will. We intend to act in your behalf, and do whatever it takes to ensure that your rights and remedies are protected.

WHAT WE WILL DO

We will investigate the circumstances surrounding every transaction mentioned in the indictments. We will then pull the order tickets for these trades, review the time-and-sales reports and notify customers of our findings. The Exchanges have rules and procedures to compel the payment of monies to customers in circumstances where it is found that orders have been mishandled.

WHAT YOU CAN DO

Any Lind-Waldock customer who has questions about the investigation need only telephone his trading desk. Our internal procedures, and the role of the compliance department, will be explained to you. Call us.

Barry J. Lind

Clearing Member Principal Commodity Exchanges

LIND-WALDOCK

The Nation's Largest Futures Discount Firm

30 South Wacker Drive, Chicago, Illinois 60606, 1-800-621-0762



Barry Lind, Chairman Lind-Waldock

"You've seen a lot of messages from us over the past nine years."

We've communicated with thousands of futures traders and market watchers through our ads in Futures Magazine. Sometimes we've used our advertising as a way of speaking out on issues that we feel are vital to our customers and to our industry.

Now, amid allegations that certain individuals have violated our trust...and yours...we want to tell you where we stand.

Quite simply, we stand for our customers. We earn our customers' confidence every trading day through performance and accountability. Our interests and those of our customers are, and always have been, inseparable.

It's why our customers stay with us long term. It's why so much of our business comes from customer referrals. It's why Lind-Waldock is the number one discount futures brokerage firm. Because that's the way it's been for all the years we've been in business.

Barry J. Lind

Clearing Member Principal Commodity Exchanges

LIND-WALDOCK

The Nation's Largest Futures Discount Firm

30 South Wacker Drive, Chicago, Illinois 60606, 1-800-621-0762

For more information circle No. 71

The most dependable message on this page for the past nine years:

Every week, when you've turned to the Futures Prices Page, we've been right here. Through bull markets and bear, the coming, going, and altogether changing of quite a few firms, Lind-Waldock has been here all along.



save while they trade. We've developed computerized speed for our customers' orders; expanded our work day to 24 hours during the trading week; and designed a complimentary trading package especially for our new customers.

And in all these years, our message has remained virtually the same: that is, our sole business is providing futures traders with exceptional brokerage services at affordable commissions.

The message is clear: you can depend on Lind-Waldock. That's why we're America's largest discount firm.

Not to say that we haven't changed. The past nine years have seen our business grow over 1500% in size as more and more traders turn to us to

If you're ready now, call us or send the coupon below. You'll discover just how dependable we really are. And, if you're not ready yet, keep flipping to this page, we'll be right here.

Barry Lind, Chairman

"Please send me new account information."

Name

Address

City State Zip

Day Phone

1-800-621-0762

Clearing Member Principal Commodity Exchanges

LIND-WALDOCK

The Nation's Largest Futures Discount Firm
30 South Wacker Drive, Chicago, Illinois 60606

THE WALL STREET JOURNAL

TUESDAY, MAY 2, 1989

Individual investors speak out on the futures industry, the investigations and Lind-Waldock

RESULTS OF THE LIND-WALDOCK TRADERS' SURVEY:

At Lind-Waldock, we wanted to know how our customers feel about the industry and about our performance as their brokerage firm. To find out, we surveyed over third of our active customers. Of the over 4,300 surveys sent, we received 1,142 back or 26%. Here are the pertinent results of those responding to the following questions:

ABOUT THE FUTURES INDUSTRY

Do you feel you have been well served by the current open outcry system in the filling of your orders? Yes-78% No-22%

Do you think the exchanges do a satisfactory job of policing themselves? Yes-37% No-63%

Should there be more government regulation? Yes-38% No-62%

From your own trading experience, do you believe that the trading pits at the exchanges operate with honesty and efficiency? Yes-69% No-31%

ABOUT THE INVESTIGATIONS

Has the investigation changed the way you trade? . . . Yes-20% No-80%

Which statement best describes your current situation?
Trading less . . 6% Stopped trading . . 1% Changed type of orders . . 12%

Are you following news reports of these investigations? Yes-87% No-13%

Describe how you feel the stories are being presented:
(check as many as you feel to be appropriate)

Informative 62%	Sensationalized . . . 30%	Unbiased 17%
Accurate 41%	Redundant 14%	Biased 13%

ABOUT LIND-WALDOCK

What aspects of "service" are most important to you? (ranked as number one or two of six)	Now rate Lind-Waldock in each area: (on a scale from 1-10; 10 being the highest)
	Fill quality Competitive Security for your funds
1. 64% Fill quality	10 31% 45% 60%
2. 45% Competence of order takers	8-9 42% 36% 24%
3. 45% Security for your funds	6-7 15% 9% 7%
	4-5 4% 3% 3%
	2-3 5% 5% 3%
	1 3% 2% 3%

Have you traded with any futures firm(s) besides Lind-Waldock? Yes-78% No-22%

How would you rank our fill quality as compared to theirs?	How would you rank our service overall?
Much better 24%	Much better 30%
Better 37%	Better 41%
The same 31%	The same 15%
Worse 7%	Worse 5%
Much worse 1%	Much worse 0%

Have you ever had a specific complaint regarding fill quality at Lind-Waldock? Yes-42% No-58%

Did you report it to us? Yes-82% No-18%

Did you find that we were already checking the price? Yes-37% No-63%

Were you satisfied that we represented your best interests? Yes-79% No-21%

Are you satisfied with our call-back time with fill information? Yes-77% No-23%

Do you feel that as your brokerage firm, Lind-Waldock looks out for your best interests in the execution of your orders? Yes-93% No-7%

To us, the experts are our customers. We're proud of the way they feel about the industry and about what they have to say about us. We work very hard to deliver the best service in the industry. After all, that's our only product.

1-800-621-0762

Clearing Member Principal Commodity Exchanges

LIND-WALDOCKThe Nation's Largest Futures Discount Firm
30 South Wacker Drive, Chicago, Illinois 60606

LIND-WALDOCK & COMPANY

Clearing Member Principal Commodity Exchanges

EXHIBIT

Dear Futures Trader:

Enclosed are the results of a survey we believe you should know about.

Lind-Waldock recently polled approximately one third of our active customers with the goal of learning a little something about both our firm and the futures industry from the people we regard as the true experts — our customers. We asked direct questions and invited their comments and suggestions in two key areas.

First, we asked our customers what they think of Lind-Waldock as their brokerage firm. We wanted to know what our traders regard as our strengths and weaknesses, and how we might best improve our overall level of service.

Secondly, in the wake of allegations regarding improprieties in the trading pits, we were concerned with how the futures industry is perceived by the trading public, and we felt it was time someone asked individual investors for *their* opinions.

A full 20% of those surveyed responded, and we were surprised and delighted by their candor. Frankly, we are proud of what our customers had to say, not only about Lind-Waldock, but about the futures industry as well.

We hope you'll take a few moments to read and consider the survey results. They will tell you more about the kind of service you'll receive from Lind-Waldock than we ever could.

Sincerely,

Barry Lind
Chairman

The Chicago Mercantile Exchange Center

30 South Wacker Drive
Suite 1712

Chicago, Illinois 60606
312-648-1400

Telex 910-221-0081

**LIND-WALDOCK
1989 SURVEY**

April 25, 1989

Survey Totals

Sent: 4,353
Received: 1,142 (26%)
Through April 18, 1989

Investigation of the Futures Industry

1. Are you aware of the current investigation into trading pit improprieties?

Yes - 1099 (99%) No - 11 (1%)
1,110 responded

If "Yes," please continue with questions 2 - 8.

If "No," please skip to next section, "Personal Trading Information".

2. What is your source(s) for information on the investigation?

Local Television News	381
Network Television News	646
Local Newspaper	474
Wall Street Journal	833
Word of mouth	118
New York Times	141
Other	254

3. Are you following news reports of these investigations?

Yes - 943 (87%) No - 142 (13%)
1,085 responded

If "Yes," please describe how you feel the stories are being presented:
(Check as many as you feel to be appropriate.)

Accurate	383 (41%)
Sensationalized	280 (30%)
Informative	587 (62%)
Redundant	129 (14%)
Unbiased	165 (17%)
Biazed	127 (13%)
Other	85 (9%)

Percentages are based on 943 respondents who answered 'yes'.

**LIND-WALDOCK
1989 SURVEY**

April 25, 1989

4. From your own trading experience, do you believe that the trading pits at the exchanges generally operate with honesty and efficiency?

Yes - 690 (69%) No - 307 (31%)
997 responded

5. Has the investigation changed the way you trade?

Yes - 218 (20%) No - 860 (80%)
1,078 responded

If "Yes," check which statement best describes your current situation.

Trading less	68 (6%)
Taking a wait-and-see attitude	33 (3%)
Stopped trading	12 (1%)
Changed the type of orders I place	137 (13%)
Other	32 (3%)

Percentages are based on total respondents (1,078).

6. Do you believe you have been well served by the current open outcry system in the filling of your orders?

Yes - 764 (78%) No - 212 (22%)
976 responded

7. Do you think the exchanges do a satisfactory job of policing themselves?

Yes - 369 (37%) No - 640 (63%)
1,009 responded

If "No", should there be more government regulation?

Yes - 260 (38%) No - 424 (62%)
684 responded

**LIND-WALDOCK
1989 SURVEY***April 25, 1989*

8. Do you feel that as your brokerage firm, Lind-Waldock looks out for your best interests in the execution of your orders?

Yes - 939 (93%) No - 69 (7%)
1,008 responded

Personal Trading Information

1. How long have you been trading futures (in years)?

<3	259 (24%)
3-5	281 (25%)
6-10	264 (24%)
>10	298 (27%)

1,102 responded

2. How long have you been trading with Lind-Waldock (in years)?

<3	538 (52%)
3-4	283 (27%)
5-6	129 (12%)
>6	90 (9%)

1,040 responded

3. How many trades do you place in an average month?

<5	435 (42%)
5-10	335 (33%)
>10	260 (25%)

1,030 responded

Service Ranking

1. What aspects of "service" are most important to you? In column "a", rank the following in order of importance to you from 1 to 6; 1 being the most important.

a.:

	<u>Fill</u>	<u>Competence</u>	<u>Security</u>	<u>Commission</u>	<u>Courtesy</u>	<u>Confirmations</u>
1.	274 (30%)	195 (21%)	328 (35%)	70 (8%)	45 (5%)	40 (4%)
2.	318 (34%)	227 (24%)	97 (10%)	144 (16%)	53 (6%)	96 (10%)
3.	176 (19%)	196 (21%)	121 (14%)	220 (24%)	66 (7%)	146 (16%)
4.	94 (10%)	189 (20%)	123 (13%)	185 (20%)	152 (16%)	176 (19%)
5.	42 (5%)	111 (12%)	117 (13%)	176 (19%)	234 (25%)	236 (26%)
6.	21 (2%)	12 (1%)	139 (15%)	132 (14%)	376 (41%)	231 (25%)
	925	930	925	927	926	925

2. Have you traded with any futures firm(s) besides Lind-Waldock?

Yes - 859 (78%) No - 249 (22%)
1,108 responded

Account Number (optional): 600 gave account number (53%)

Please use the following space to elaborate on any aspect of our service or on the investigations, whether or not it has been covered in the survey.

659 gave additional comments (58%)

LIND-WALDOCK
1989 SURVEY

April 25, 1989

Survey Comments

On Regulation:

"More government regulation seldom helps. Here's hoping that self-policing by the exchanges can be improved."

"I'm strongly against any reform proposals which will reduce market liquidity."

"I'm afraid the Feds may wind up reducing liquidity and volume in the pits, causing significantly increased transactions costs..."

"99% of the trading is honest, which is considerably better than most businesses. I have only had one fill in 20 years of trading that I could not attribute to market volatility."

On News Reports of the Investigations:

"As sensationalized and biased as they are, the news reports have one good effect: pressure on the exchanges to do a better job. The potential bad effect is increased gov't interference—there's too much of that already."

"I feel the news reports on the investigations are overly exaggerated. We do not need more government regulations but more enforcement of current regulations."

"I believe that the futures industry must emphasize the important role it plays in our economy as a price finder as well as a vehicle to transfer risk ... Strict enforcement of exchange rules as well as a more informed public as to the importance of the futures industry should reduce the chances that the industry will become the whipping boy for the press or government officials in the future."

On Open Outcry Trading:

"From what I've heard/read on the subject, I'm in favor of gradually replacing the open outcry system with computer-controlled trading systems. I think this would provide faster, fairer, more efficient fills, as well as establishing a better "paper trail" for audit purposes."

"All orders should be open outcry, but transmitted by computer to the pit."

"Open outcry must be kept even though imperfect — any attempt to automate would seem to be a "black box" in which I could place no confidence. Public viewing of trading is necessary."

"I'm firmly in favor of honest open outcry as the market making system — that's why I trade futures. The stock market is too computerized and removed from reality."

On Dual Trading:

"I think that the individual traders who handle customer orders on the floor should not be allowed to trade for themselves the same day they trade for a customer. I'm glad that Lind-Waldock, as a firm, does not trade for its own account."

"I feel that allowing a trader in the pits to trade his own account as well as the customers' accounts sets up a basic conflict of interests; however, there has been no evidence of any problem in my experiences with Lind-Waldock."

On Lind-Waldock:

"As a former member of the Chicago Board of Trade, I think you do an exceptional job overall. As for fills, I don't think (most times) that I could have done better if I were in the pit filling my own orders."

"Thank you for being a very good broker even before the bad news was made public."

"Although the investigations have heightened my interest and altered the way I specify orders, I will continue to trade. I have always been impressed with the service I receive at Lind-Waldock."

Barry J. Lind
Chairman, Lind-Waldock & Co.

Barry J. Lind first began trading futures in 1962 and was an active floor trader for over twenty years. In 1962, he had developed enough public business to open his own retail, full-service firm.

From his earliest days of membership, Mr. Lind has been active as both a trader and a leader of the Chicago Mercantile Exchange (CME). In 1970, he was elected to the first of five, two-year terms on the CME's Board of Governors. During that time, he served as Vice Chairman and Treasurer of the Board of Governors; Chairman of the Exchange's Clearing House Committee; and Chairman of the Finance Committee. He was instrumental in the creation of the International Monetary Market, the formation of its Clearing House and the rules thereof. Mr. Lind then served as its Vice Chairman.

Most recently, Mr. Lind has served on the CME Business Conduct Committee, on the CME Financial Instruments Steering Committee, and on the CME Strategic Planning Committee. He also served on the Exchange's Expansion Committee which developed the member rights program. He is advisor to the CME Clearing House Committee and is a member of the Singapore Steering Committee. Since the inception of the Commodity Futures Trading Commission (CFTC), he has served as Chairman on a CME special committee addressing the CFTC's capital requirements for Clearing Member firms.

Mr. Lind's leadership roles within the industry also include serving on the Finance Committee of the National Futures Association (NFA), and he has been on its Board of Directors since its inception. In addition, he chaired a special committee to deal with the CFTC's proposal on minute-to-minute time stamping with the intent of making the system more equitable for customers. This step led to the development of Computer Trade Reconciliation (CTR). Mr. Lind also serves on the Financial Products Advisory Committee (FPAC), which is the only advisory committee to the CFTC.

He actively participates as an expert consultant in matters of clearing and capital requirements for both the Exchange and the industry's regulating agencies.

Barry Lind is Chairman and the largest stockholder of Lind-Waldock & Company, a Clearing Member firm at the CME since 1965. His firm currently holds roughly \$220 million in customer segregated funds and has in excess of 500 employees. Lind-Waldock's business stems mainly from its position as the largest retail, discount firm of any non-broker-dealer. The firm also provides clearing services for professional floor traders and operates a fast-growing institutional division.

Mr. Lind has authored many articles, including a section on futures trading for *Encyclopaedia Britannica*. He has also been the subject of features in such publications as *Forbes*, *Business Week* and *Institutional Investor*. His booklet, "Method Trading," also has gained great popularity among public and professional traders.

A 1960 graduate of Northwestern University with a Bachelor of Science in business, Mr. Lind is fifty years of age.

LIND-WALDOCK & COMPANY

Lind-Waldock & Company is the largest futures discount firm in the United States and ranks in the top twenty of all futures trading firms in terms of customer funds on deposit.

In 1965, Barry J. Lind, a professional floor trader, established the brokerage firm now known as Lind-Waldock. Initially designed as a full-commission, retail firm, Lind restructured the company's operations in 1980 to become the futures industry's first discount commodity brokerage firm. Eliminating the customer broker-middleman who provided advice and research, Lind concentrated on customer order execution and was able to cut commission charges by 50% - 80%.

The streamlined system has customers calling for order placing and quotes directly to Lind-Waldock's 24-hour Trading Center at the firm's headquarters in Chicago. There they are assigned to a trading desk of five or six order specialists who assist them in order placement and give them instant price quotes. The system is designed to expedite service while dealing with people familiar with the customer's account; to provide fast, accurate execution and clearing services without offering market opinion.

To accommodate its large customer base (approximately 13,000 active customers) and to enhance speed, Lind-Waldock developed its computerized order entry system, Order Express. The system transmits most customer orders in 1.5 seconds from a centralized location to one of 22 Lind-Waldock floor desk locations nearest to the trading pit for execution.

Customer transactions are then processed by the firm's 24-hour-a-day back office operation. Each customer's account is immediately updated to reflect fill information, transactions and open positions, and customers receive daily and monthly activity statements. Lind-Waldock clears approximately 30,000 futures and options contracts per day for its customers.

Under the discount concept, Lind-Waldock has nearly quadrupled in size in the last five years alone; from \$80 million in customer deposits in 1984 to over \$220 million today, giving Lind-Waldock an estimated 60% of the discount futures market. The firm employs over 500 employees, including an operations and floor staff of 35 people in New York City.

Lind-Waldock is a registered Futures Commission Merchant (FCM) and a clearing member of seven major U.S. commodity exchanges; the Chicago Board of Trade (CBOT), the Chicago Mercantile Exchange (CME), the Commodity Exchange, Inc. (COMEX), the New York Coffee, Sugar and Cocoa Exchange (NYCSCE), the New York Cotton Exchange (NYCTE), the New York Futures Exchange (NYFE) and the New York Mercantile Exchange (NYME).

**STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, NATIONAL
FUTURES ASSOCIATION, CHICAGO, IL**

Mr. WILMOUTH. Thank you, Chairman Leahy, Senators Lugar and Boschwitz.

INTRODUCTION

My name is Robert K. Wilmouth and I am the president of National Futures Association (NFA).

As I think all of you know, our primary responsibility is to protect the investing public in the futures industry, with certain designated assigned responsibilities—registration of all commodity professionals and firms; we perform financial and sales practice compliance audits, and we also offer an arbitration and an education service.

I would like to comment very briefly on several issues in the legislation which directly impact NFA.

**WE STRONGLY SUPPORT THE PROPOSED AMENDMENTS DEALING WITH
REGISTRATION FITNESS STANDARDS**

First, we strongly support the proposed amendments dealing with registration fitness standards. It is our view that the proposed amendments to the disqualification provisions of the act will strengthen the fitness standards of the futures industry, promote fairness and uniformity of treatment, and further serve to streamline and simplify the registration disqualification procedures.

The entire futures industry, I believe, can be justly proud that its sales practice regulations are already second to none in their comprehensiveness and their effectiveness.

TELEMARKETING PROVISION OF THE BILL

The telemarketing provision of the bill would provide further help to enable NFA to pinpoint those firms which need to adopt enhanced telemarketing supervisory procedures, such as the proposed 3-day cooling off period to meet a diligent supervision standard.

**STRONGLY SUPPORT THE PROPOSED CHANGE TO SECTION 17(i)(4) OF THE
ACT**

We also strongly support the proposed change to section 17(i)(4) of the act. The proposed change would ensure that any CFTC order reducing a sanction imposed by NFA could be reviewed in court and would provide the public with the same protection afforded the alleged rule-violator.

Mr. BOSCHWITZ. Pardon me, Bob. You are not following the written statement.

Mr. WILMOUTH. No. I am just trying to synopsize my written comments, which are about 30 pages, in a few moments.

Mr. BOSCHWITZ. Fine.

SERVICE CHARGES

Mr. WILMOUTH. On the subject of service charges, we believe, as yesterday's testimony revealed, that there needs to be some further

clarification in this area, bearing in mind two things. First of all, the trading public already funds approximately 80 percent of NFA's budget of \$26 million a year through assessment fees. I would also remind the committee that the exchange members are bearing an enormous burden in terms of picking up all of the costs that are going to be associated with exploring new technology.

PUBLIC REPRESENTATION ON OUR BOARD OF DIRECTORS

With respect to public representation on our board of directors, NFA has always recognized the valuable perspective which comes from outside representatives. In all, 8 of the 42 seats on our board, or roughly 19 percent, are set aside for persons who are not registered in any capacity under the act and who are not regulated by NFA.

The language of the proposed amendment would require at least 20 percent of our board to consist of "nonmembers." Because commercial firms and commercial banks, although not subject to NFA regulation, may be members of NFA, we would suggest a simple kind of technical amendment that changes the proposed language of the bill from "nonmembers" to "individuals not subject to regulation by the association". We think that would more accurately reflect our membership structure and be faithful to the committee's intent in terms of forming the bill.

COMMENT ON THE OBSERVATIONS OF MY GOOD FRIEND SENATOR TOM EAGLETON

One final note, Mr. Chairman, if I may take you up on your invitation to make comments on other remarks that have been made. I would like to just very briefly comment on the observations of my good friend Senator Tom Eagleton, whom I hold in a great deal of affection and admiration. I recently served as an adviser to the CME Special Committee on Trading Floor Practices, on which Senator Eagleton served as a member. I disagree with several of his observations, particularly those regarding the self-regulatory process and open outcry.

Contrary to Senator Eagleton's statement, no one has ever suggested that self-regulation is, in his words, the be-all and the end-all of regulation. For over 140 years, self-regulation has provided an effective first line of defense against unethical business conduct. Self-regulation works because I think businessmen in this business recognize that it is in their best interest to police themselves, and I think the events of the past few months have very clearly brought that to the forefront. I also think that the United States' emphasis on self-regulation with strong oversight from a strong Commodity Futures Trading Commission is being copied by foreign jurisdictions, and it should not be rejected or shackled as the result of a relative handful of individuals who have broken some of the rules.

IT IS MY PERSONAL OPINION THAT AUDIT TRAILS, OPEN OUTCRY, AND ELECTRONIC TRADING ARE NOT INCOMPATIBLE

Finally, based upon my 5 years' experience as president of the Chicago Board of Trade and another 7 years as president of the self-regulatory body, NFA, it is my personal opinion that audit

trails, open outcry, and electronic trading are not incompatible. They can all be worked together. And I think that this industry has the talent; I think we have the financial resources, and more importantly, I believe very strongly that this industry has the desire to preserve the integrity of the futures market. I believe we will succeed, with your help.

Thank you, Senator.

[The prepared statement and appendix to testimony of Mr. Wilmouth follow:]

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY
RE: 1729

OCTOBER 17, 1989

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY
RE: S. 1729

Chairman Leahy, Distinguished Members of the Subcommittee, Ladies and Gentlemen.

I. INTRODUCTION

My name is Robert K. Wilmouth and I am the President of National Futures Association. NFA welcomes this opportunity to present its views on the proposed legislation pending before this Committee. The issues involved are both complex and important. Congress must once again perform a difficult balancing act. On the one hand, Congress must provide sufficient regulation to ensure the fairness of and public confidence in U.S. futures markets. On the other hand, Congress must avoid unduly burdensome regulations which could impair the efficiency and usefulness of those markets and erode the position of U.S. markets in an ever-more competitive global marketplace.

From its unique position in the regulatory structure of the industry, NFA may have a somewhat different perspective than some of those who will testify before you. As envisioned by Congress and implemented by our Board, NFA was never intended to duplicate, and has not duplicated, the regulatory efforts of the exchanges. NFA's authority, therefore, focuses not on exchange trading floors, but on all other aspects of its Members' dealings with the public. NFA's primary responsibilities include:

- developing and enforcing customer protection rules to ensure that Members observe the highest possible ethical standards in their business and sales practices;
- preventing unethical firms and individuals from entering the industry by performing the registration function on behalf of the Commission;
- protecting customers by educating them about the futures markets and their risks so that customers can make fully informed investment decisions; and
- providing customers with an arbitration forum which provides a fair, prompt and inexpensive means of resolving disputes.

NFA's accomplishments in each of these areas since the last reauthorization have been detailed in a lengthy report we have previously provided to each of you. The Executive Summary of that report is attached to my written submission.

Certain of the proposed amendments to the Act that you are considering would directly impact NFA in carrying out our regulatory responsibilities. I would like to comment on those proposals with some specific observations. Other issues you are dealing with may not directly impact NFA but could have a profound impact on the futures industry. On those issues NFA is a very interested bystander and I would offer more general observations on those points.

II. REGISTRATION REQUIREMENTS

One of the best ways to protect the public from unscrupulous firms and individuals is to keep those people out of the industry in the first place. That is the job that NFA has been handling since October 1, 1985, when it assumed responsibility for denying, revoking, restricting or conditioning registration for all categories except floor brokers and leverage transaction merchants. NFA has done that job by applying the two-tiered system of disqualifications from registration which Congress established in 1982. Sections 8a(2) and 8a(3) of the Act have proved to be effective tools in maintaining the high fitness standards of the futures industry, but NFA agrees with the Committee that those provisions can be fine-tuned and improved. NFA strongly supports the proposed amendments.

In general, the proposed amendments will tighten the fitness standards of the futures industry. At the same time, the suggested amendments retain the critical distinction between the more egregious disqualifications set forth in Section 8a(2) of the Act and the less serious disqualifications set forth in Section 8a(3) of the Act.

The proposed amendments would also codify certain of the Commission's and NFA's prior interpretations of the existing disqualification provisions and would resolve certain ambiguities in the Act which NFA has encountered over the past few years.

To summarize, it is NFA's view that the proposed amendments to the disqualification provisions of the Act will strengthen the fitness standards of the futures industry, promote fairness and uniformity of treatment among similarly situated applicants and registrants and further serve to streamline and simplify registration disqualification proceedings. A more detailed analysis of NFA's support of the proposed amendments is set forth below.

Section 8a(2)(C)(ii) of the Act

At the present, Section 8a(2)(C)(ii) of the Act provides, in pertinent part, that a person is disqualified from registration if he is permanently or temporarily enjoined from "engaging in or continuing any activity involving any transaction in or advice concerning contracts of sale of a commodity for future delivery...or concerning securities." NFA favors the proposed amendments to this provision which encompass the most serious types of injunctions, regardless of whether such injunctions involve futures or securities, such as those involving theft, fraud, fraudulent conversion, misappropriation of funds, securities or property and false pretenses.

Section 8a(2)(D) of the Act

At present, Section 8a(2)(D) of the Act provides that certain types of serious felony convictions within the last ten years qualify as disqualifications from registration. NFA favors amending Section 8a(2)(D)(iv) of the Act to include serious felony offenses under other sections of titles 18 and 26 of the United States Code. Virtually every criminal federal case involving commodities or securities includes violations of one or more of the following federal criminal statutes which are not currently included in Section 8a(2)(D)(iv) of the Act:

- 1) 18 U.S.C. § 1001 (false statements);
- 2) 26 U.S.C. §§ 7201 and 7206 (tax evasion and tax fraud);
- 3) 18 U.S.C. § 1503 (obstruction of justice);
- 4) 18 U.S.C. § 1623 (perjury);
- 5) 18 U.S.C. § 2314 (interstate transportation of stolen property); and
- 6) 18 U.S.C. §§ 1961-1963 (racketeering).

NFA contemplates that Section 8a(2)(D)(iv) will be significantly strengthened if these serious felony convictions are added to the list of disqualifying offenses.

Section 8a(2)(E) of the Act

Section 8a(2)(E) of the Act currently disqualifies persons who have been found to have violated certain serious provisions of a number of specified federal and state statutes and the regulations, rules or orders thereunder. The Commission has indicated in an interpretive notice that, as currently drafted, Section 8a(2)(E) may be interpreted to authorize the Commission to affect the registration of a person subject to findings described in such Section, which are made in a proceeding initiated by a private party either in a court of law or in a reparations matter. The Commis-

sion has indicated, however, that such private litigation is intended primarily to provide restitution to the customer and is not intended to be punitive in nature. Thus, the Commission has decided that it may be inappropriate to use findings in such proceedings to affect the registration of any person under Section 8a(2)(E) of the Act. However, the Commission has made it clear that such findings may be used to initiate a disqualification proceeding under Section 8a(3)(M) of the Act. See Appendix A to Part 3 of the Commission Regulations, 1 Comm. Fut. L. Rep. ¶2220L at 2346 (1984).

NFA supports the proposed amendments to Section 8a(2)(E) which would codify the Commission's interpretive statement on this Section. The proposed amendments restrict this Section's applicability to administrative proceedings brought by the Commission, or any federal, state or other governmental body. NFA also supports amending Section 8a(2)(E) to include violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). NFA shares the Committee's view that violations of RICO are as serious, if not more so, than certain of the violations of the statutes currently enumerated in Section 8a(2)(E).

Section 8a(2)(G) of the Act

Section 8a(2)(G) of the Act disqualifies from registration any person who willfully makes any false or misleading statement or omitted to state any material fact in his registration application with respect to matters set forth in Sections 8a(2)(A) through (F) of the Act. NFA supports the proposed amendments to this Section which would disqualify any person who makes any willful material omission or misleading statement concerning any disqualification under either Section 8a(2) or Section 8a(3) of the Act.

It is well-established that NFA's fitness determinations depend, in part, on full disclosure of all material information. NFA agrees that it is highly inappropriate to allow an applicant to obtain a temporary license or for a registrant to remain registered, who has failed to disclose the fact that he may be subject to a statutory disqualification. The inappropriateness of allowing a deceptive person to obtain or retain registration does not lessen because he may be subject to a Section 8a(3) rather than a Section 8a(2) disqualification. NFA believes that Congress can underscore the importance of full disclosure on registration applications and amendments thereto by adopting the proposed changes.

NFA also supports the proposed amendments which make it clear that omissions and misleading statements in updates to registration applications will disqualify a person from registration.

Section 8a(3)(D) of the Act

Section 8a(3)(D) of the Act disqualifies from registration persons convicted of felonies other than the type specified in Section 8a(2)(D) of the Act within ten years of filing a registration application, as well as persons convicted of Section 8a(2)(D) type felonies more than ten years preceding the filing of an application.

NFA favors amending Section 8a(3)(D) to include not only situations where a person has actually been convicted of a felony, but also those instances where a person pleads guilty to such offense, even though not formally convicted.

In August 1988, NFA adopted the policy of initiating a disqualification action under the "other good cause" provision of Section 8a(3)(M) against persons who pleaded guilty to a felony, although adjudication was withheld. NFA instituted this policy because it determined that a person who pleaded guilty to a felony may be unfit to be registered, regardless of whether or not he was formally convicted. NFA was concerned that such person's treatment under the Act not be contingent upon the vagaries of particular states' laws.

The proposed amendment to Section 8a(3)(D) will codify NFA's practice of initiating disqualification proceedings against persons who have pleaded guilty to a felony offense even though they have not been formally convicted. NFA expects that the proposed amendment will have the effect of promoting uniformity of treatment among similarly situated persons.

NFA also supports the Committee's proposal to eliminate the ten-year limit on felony convictions other than the type specified in Section 8a(2) of the Act. Currently, in appropriate cases, NFA initiates actions against persons who have been convicted of felonies other than the type specified in Section 8a(2) more than ten years ago, under the "other good cause" provision of Section 8a(3)(M) of the Act. NFA agrees with the Committee that a person's felony conviction, regardless of its age, bears directly on a person's fitness for registration and therefore favors eliminating the ten-year limit contained in Section 8a(3)(D).

NFA recognizes that the presumption of unfitness arising from such a conviction or guilty plea may well be less than that arising from a more recent conviction. Moreover, it may very well be that a person with an older felony conviction or guilty plea may be able to present more substantial rehabilitation evidence than someone who had pleaded guilty or had been convicted of a felony more recently. However, it is NFA's view that these factors

relate to the issue of what weight should be accorded such conviction or guilty plea, not whether such conviction or guilty plea constitutes a disqualification in the first place.

Section 8a(3)(E) of the Act

Section 8a(3)(E) of the Act disqualifies from registration persons who have been convicted of certain serious misdemeanor convictions within the past ten years. NFA supports the Committee's proposal to amend Section 8a(3)(E) by eliminating the ten-year time limit and by including instances where a person pleads guilty to a misdemeanor offense, although not formally convicted. These proposed amendments parallel those suggested under Section 8a(3)(D) of the Act.

The proposed changes to Section 8a(3)(E) would serve to codify NFA's practice of initiating cases under Section 8a(3)(M) of the Act, against persons who, although not formally convicted, pleaded guilty to serious misdemeanors and against persons whose serious misdemeanors are over ten years old. NFA expected that the proposed amendments will promote uniformity of treatment among similarly situated persons. NFA also favors supplementing the list of statutes currently enumerated in Section 8a(3)(E) to include those involving conspiracy, tax evasion and tax fraud. NFA agrees that adding these kinds of serious misdemeanors to Section 8a(3) will significantly strengthen the reach of that provision.

Section 8a(3)(G) of the Act

Section 8a(3)(G) of the Act disqualifies from registration a person who willfully makes any materially false or misleading statement or who willfully omits to state any material fact in such person's application, in any report required to be filed with the Commission, or in any proceeding before the Commission. In view of the fact that NFA also conducts registration disqualification proceedings, NFA agrees that it is appropriate for the Committee to adopt amendments to Section 8a(3)(G) of the Act which will encompass willful omissions or materially false or misleading statements made by a person in the course of a disqualification proceeding conducted by NFA. NFA also supports the proposed amendment that makes it clear that omissions and false and misleading statements contained in updates to a person's registration application will constitute a disqualification from registration.

Section 8a(3)(H) of the Act

Section 8a(3)(H) of the Act disqualifies from registration persons who have pleaded nolo contendere to

criminal charges of felonious conduct, or who have been convicted in a state court or in a foreign court of conduct which would constitute a felony under federal law if the offense has been committed under federal jurisdiction. NFA supports the proposed amendment to Section 8a(3)(H) which would broaden this provision to encompass convictions in United States military courts of offenses regarded as felonies under federal law.

It has been NFA's experience that United States military courts, like certain state and foreign courts, do not always explicitly distinguish between felony and misdemeanor offenses. Thus, it seems appropriate to include a reference to such courts in Section 8a(3)(H) of the Act.

In the past, NFA has initiated under the "other good cause" provision of Section 8a(3)(M) of the Act, an action against a person who was convicted in a United States military court of an offense which would be considered a felony under federal law. The proposed amendment would codify NFA's practice in this regard.

Section 8a(3)(J) of the Act

Section 8a(3)(J) of the Act currently disqualifies from registration persons who are subject to an outstanding order denying, suspending, or expelling such person from membership in a contract market, a registered futures association, or any other self-regulatory organization ("SRO"), or barring or suspending such person from being associated with any member or members of such contract market, registered futures association or SRO.

NFA favors amending Section 8a(3)(J) of the Act to include as disqualifications from registration denials, bars, suspensions and expulsions from foreign regulatory organizations which the Commission has recognized as having a comparable regulatory program to that of the Commission's. The proposed amendment will prevent persons who have been severely sanctioned by foreign regulatory bodies from obtaining registration under the Act.

I have just one final point regarding registration. If Congress decides to require the registration of floor traders, I can assure you that NFA would be capable of assuming that processing function if requested to do so.

III. TELEMARKETING FRAUD

No job is more important to NFA than the prevention of deceptive sales practices by NFA Members, and that is precisely where we have focused our rulemaking and rule enforcement efforts. The entire futures industry can be justly proud that its sales

practice regulations are second to none in their comprehensiveness and effectiveness.

To begin with, there's the CFTC regulations regarding risk disclosures for both futures and options. The futures risk disclosure statement in CFTC Regulation 1.55 describes the risks of futures trading in a one-page statement written in plain language that would scare the spots off a leopard. The options risk disclosure is equally effective and thorough. NFA's "Know Your Customer" rule takes those risk disclosures one step further by requiring that certain customers have to be warned that futures trading is just too risky for them and that they do not belong in these markets. On top of all of that, NFA Compliance Rules not only bar high-pressure sales practices -- they actually require that any standardized telephone solicitation which even mentions the possibility of profit must be accompanied by an equally prominent statement of the risk of loss. Considering all of these rules, together with all of the other anti-fraud provisions of the Commodity Exchange Act, CFTC regulations, exchange rules and NFA rules, I am not aware of any industry selling any product anywhere that has a more pervasive network of customer protection regulations.

Furthermore, those regulations are being aggressively enforced. Comparing NFA's first three years to the last three years, sales practice complaints increased from 12 to 66, expulsions from 12 to 39 and fines from just over \$100,000 to over \$1,000,000. All of this is in addition to the numerous significant sales practice cases which the Commission has brought.

Notwithstanding all of the rules that already exist and the effective enforcement of those rules, NFA feels that if even one customer is the victim of a deceptive or high-pressure sales pitch from an NFA Member, that is one victim too many, and we would welcome any legislation which would help combat that tiny percentage of our membership which engages in this type of conduct. This legislation would do just that.

All NFA Members are required to diligently supervise the activities of their employees, including the telemarketing activities of their account executives. However, Members vary widely in the type of business that they do, the clientele they serve and the sales force they employ. What constitutes diligent supervision at one firm may not constitute diligent supervision at another.

This provision of the bill would enable NFA to pinpoint those firms which, based on articulable standards set by NFA and approved by the Commission, need to adopt enhanced telemarketing supervisory procedures, such as the proposed three-day cooling off period, to meet the "diligent supervision" standard.

IV. SECTION 17(1)(4)

We strongly support the proposed change to Section 17(1)(4) of the Act. The current language of that section could be read to expressly prohibit NFA from seeking judicial review of a Commission order overturning an NFA disciplinary action. There is no sound policy reason for treating NFA differently than the exchanges in this regard. While there are many significant differences between NFA's functions and the exchanges', we do have this much in common -- we are all trying to ensure that those Members who violate our rules are punished and, where appropriate, barred from membership. The proposed change to Section 17(1)(4) would ensure that any Commission order reducing a sanction imposed by NFA could be reviewed in court and would provide the public with the same protection afforded the alleged rule violator. This amendment would not affect the Commission's review of NFA actions in registration cases, where NFA essentially performs a licensing function on behalf of the Commission.

V. SERVICE FEES

NFA has always recognized the basic fairness of the premise that those who benefit from regulation should bear a fair share of its cost. We have also recognized that the people who benefit from regulation fall into several categories, including the public at large which benefits from the existence of the markets and the trading public which trades on them.

The current language of the bill is so broad, however, that the entire expense of the CFTC's budget could be shifted to the trading public and the industry, with the public at large bearing no share of the expense. Such an unfair result cannot be what the Committee intended and the language of this section should be tightened.

Furthermore, I would remind the Committee that the trading public already shoulders the considerable expense of funding NFA. The vast majority of our \$25 million budget is funded through fees assessed on the trading public. Any additional fees imposed on NFA by the Commission will ultimately be borne by that trading public. The trading public should, of course, pay its fair share of the regulatory expense but imposing additional costs on their shoulders through fees on NFA would seem to make them bear a disproportionate share of the burden.

VI. PUBLIC REPRESENTATION ON THE BOARD

With respect to public representation on our Board of Directors, NFA has always recognized the invaluable perspective which public representatives bring to the regulatory issues NFA deals with. From our very inception, our Articles of Incorporation have always provided for public representatives on our Board.

Three of the 42 persons on our Board are elected as public representatives. Their varied backgrounds bring a wealth of industry, legislative and academic perspectives to our Board.

But those public representatives are not the only outside voices on NFA's Board of Directors. Though our Articles of Incorporation allow commercial firms and commercial banking institutions to be Members of NFA, they are not regulated by NFA. We have always recognized that these important users of the futures markets could bring valuable insights to our Board. Therefore, from our very inception, our Articles of Incorporation have provided five additional seats on our Board for those two categories, with two seats allotted to commercial banks and three seats provided for commercial firms. In all, eight of the 42 seats on our Board, or roughly 19%, are set aside for persons who are not registered in any capacity under the Act and who are not regulated by NFA.

The language of the proposed amendment to Section 17(b) of the Act would require that at least 20% of our Board consist of "non-members." Because commercial firms and commercial banks may be Members of NFA, we would suggest the proposed language be changed from "non-members" to "individuals not subject to regulation by the association." This technical change would be faithful to the Committee's intent but would more accurately reflect NFA's membership structure.

VII. AUDIT TRAILS

There are many other provisions of this bill which would not directly impact NFA but could have a profound impact on the industry as a whole. One of these involves the standards for audit trails at the exchanges.

When you step back and view this issue objectively, it seems to me there are more areas of agreement than disagreement.

- Everyone agrees that developing and maintaining the most advanced audit trail systems practicable is a critical step in ensuring the integrity of and the public confidence in our markets.
- Everyone agrees that the exchanges have in recent years made great strides in making their audit trail systems more reliable and sophisticated. If all of the reports concerning the market crash of October 1987 prove one thing, it is that the audit trail systems in the futures industry already set the standard for other markets to meet.
- Everyone agrees that although great progress has been made, more audit trail enhancements are both necessary

and possible to further detect and deter customer abuse in order execution.

- Finally, no one can deny that the exchanges are vigorously pursuing those improvements. They have put their money where their mouths are and backed up promises with deeds.

NFA could enthusiastically support legislation which ensured that those efforts would continue by setting high audit trail standards for the Commission to apply to the exchanges. I assume that that was the Committee's intent. Unfortunately, the current language of the bill goes well beyond that. The bill sets specific limits rather than general standards and only time will tell whether those specific limits are realistically achievable. The bill then goes further to subject the exchanges to draconian sanctions for failure to achieve those limits which may not be achievable. Taken as a whole, the audit trail section of the bill could doom the open outcry system which has made the U.S. markets the dominant force in this international industry and could seriously jeopardize our ability to compete in an ever more competitive marketplace.

VIII. CONFLICTS OF INTEREST

As the current president of one self-regulatory organization and the past president of another, I am very much aware of the critical need to attract the highest caliber individuals to serve on the Board and committees of any SRO. I am also aware, of course, of the need to prevent even the appearance of impropriety when the Board or committee takes any formal action. Both of these needs must be met for a self-regulatory body to function effectively, and both needs have been met in the futures industry.

All of the exchanges have extensive conflicts of interest policies to guard against even the appearance of impropriety. In attempting to provide further assurances that the second need is met, however, the bill uses language so broad that it could be impossible to meet the first need -- the need to have qualified directors on the Board. In short, this version of the bill does not merely fix something which is not broken -- it threatens to break something which has worked extremely well.

IX. FCM LIABILITY

I also question the need for certain provisions of the bill dealing with the civil liability of FCMs. One provision of Section 602, for example, would make all FCMs vicariously liable to customers for violations committed by independent floor brokers.

This provision of the bill seems premised on two rather questionable notions. First, the bill seems to assume that there is a need to provide customers who have been victimized by a dishonest floor broker with a "deep pocket" to recover from. Floor brokers are all subject to both arbitration proceedings and civil actions. I am not aware that floor brokers have routinely defaulted on any judgments which have been entered against them. The second notion seems to be that it is both fair and reasonable to make an FCM automatically liable for the acts of an individual who is not employed by that FCM. This is contrary to the long-established case law basing vicarious liability on well-recognized agency principles. If under those principles an FCM should be held liable, it will be held liable. Absent an agency relationship, however, there is no fair reason to hold the FCM liable. The premises of this provision are unsound—and it should be stricken.

In addition, this provision could have unintended side effects which could harm the efficiency of the markets and thus actually harm the users of those markets. If FCMs are going to be vicariously liable for the acts of independent floor brokers, then presumably fewer and fewer FCMs will use independent floor brokers, opting instead to use their own employees. Independent floor brokers could thus become an endangered species and the invaluable contribution they make to the liquidity of the markets would be lost.

I also question the need of that provision of Section 602 regarding punitive damages. The bill would subject FCMs to punitive damages based on the actions of an independent floor broker if the FCM "willfully and intentionally failed to exercise due diligence" in selecting the floor broker. I am not sure what this language really means. The concept of "intentional negligence" seems like a contradiction in terms. The bill thus establishes a new standard for punitive damages which is at best blurry and at worst unfair. An FCM, like any other defendant in a law suit, may be subject to punitive damages when in the judgment of the jury its conduct was such that punitive damages are appropriate to deter such conduct in the future. To establish a separate and uncertain standard applicable to FCMs alone seems both unfair and unnecessary.

X. ETHICS TRAINING

NFA also agrees with the Committee on the importance of ensuring that registrants receive adequate training concerning their ethical responsibilities to their customers. To that end, NFA has already made significant changes to the content and format of the National Commodity Futures Examination. With very limited exceptions, NFA requires all applicants for AP registration to take and pass this proficiency examination. The content of the exam has been changed over the last few years to put greater emphasis on testing the applicant's knowledge of regulatory

requirements as well as market knowledge. The questions on regulatory requirements center on those rules concerning fair dealings with customers.

NFA's Board took this process one step further in 1987 when it approved a fundamental change in the way that the exam is graded. For grading purposes, the exam is divided into two parts -- market knowledge and knowledge of regulatory requirements. The two sections are graded separately and an applicant must pass both sections of the exam in order to become registered.

The changes outlined above have already improved the industry's attention to ethics training, but we fully support any proposed amendments which will focus even greater attention on this critical area. However, given the current focus of the proficiency exam on ethical issues, we question the efficiency of requiring newly registered APs to take an ethics refresher course within six months of passing the exam and becoming registered.

XI. CONCLUSION

In conclusion, let me assure the members of the Committee that, although we may disagree with certain provisions of the bill, we strongly support the Committee's objective of fine-tuning the regulatory structure of the industry to ensure the continued confidence of the public and the continued integrity of our markets. We look forward to working with the Committee and its staff to offer any assistance we can in that effort.

DJR:cm(MISC)

APPENDIX TO

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTY
RE: S. 1729

**NATIONAL FUTURES ASSOCIATION
A CONTINUING COMMITMENT TO EXCELLENCE:
A REPORT AS OF DECEMBER 31, 1988**

EXECUTIVE SUMMARY

I. INTRODUCTION

The very concept of self-regulation is now under a cloud of suspicion. Recent press reports concerning investigations of an unspecified number of floor brokers and floor traders have caused some to question whether self-regulation can be trusted, even with diligent oversight by the Commodity Futures Trading Commission. The ultimate question is whether industry professionals have demonstrated the ability and the willingness to protect the public by policing themselves. To answer this question, Congress needs not speculation or rumor but cold, hard facts. This report provides those facts and presents overwhelming evidence that *self-regulation* is *tough* regulation.

The list of responsibilities which Congress laid out for NFA was both clear and ambitious. NFA was never intended to duplicate the efforts of either the Commission or the exchanges, and it has not done so. NFA's regulatory efforts have focused not on trading floor activity but on all other aspects of its Members' dealings with the public. NFA's primary responsibilities include:

- developing rules to ensure that the highest ethical standards are observed by Members in their business and sales practices;
- conducting investigations and audits to detect violations of those rules;
- taking disciplinary action to punish and deter such violations;
- preventing unethical firms from entering or remaining in the industry by performing the registration function on behalf of the Commission;
- preventing fraud by educating the public concerning the risks and opportunities in the futures markets so that customers can make fully informed investment decisions; and
- providing customers with an arbitration forum which offers a fair, prompt and inexpensive means of resolving futures-related disputes.

Those are the jobs which Congress and the industry have assigned to NFA. In each of these areas and the others discussed in this report, NFA's performance shows that at NFA self-regulation not only works but excels.

II. COMPLIANCE RELATED MATTERS

The formula for effective self-regulation at NFA is no real mystery. It involves three basic components — strong rules, thorough investigations and tough enforcement actions. In the past three years, NFA's continuing commitment to excellence has been evident in all three of these critical areas.

Since the date of the last full report that Congress received concerning NFA's activities, September 30, 1985, NFA has adopted or implemented numerous new rules dealing with

EXECUTIVE SUMMARY

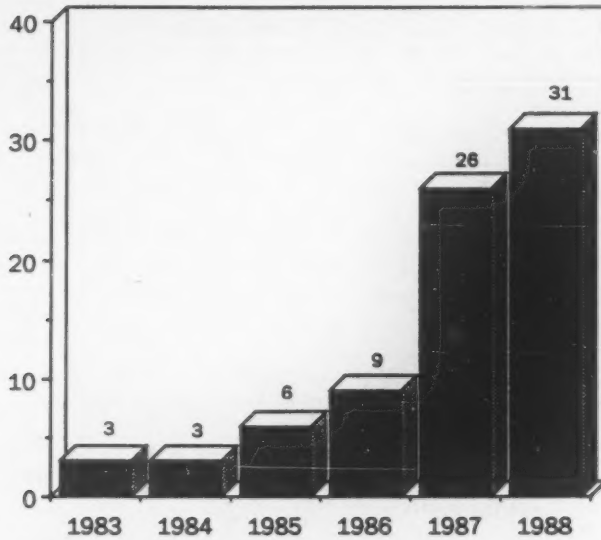
subjects ranging from telemarketing fraud and deceptive advertising to foreign futures and options:

- Compliance Rule 2-29 bars the use of high-pressure sales practices and sets strict content requirements for all telephone solicitations and advertising materials used by NFA Members;
- Compliance Rule 2-30 sets an industrywide Know Your Customer standard and provides that certain customers must be told that futures trading is simply too risky for them in light of their overall financial condition;
- NFA's *Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions* ensures that customers of NFA Members are provided with sufficient information about the costs of futures trading to make an informed decision and to compare the fees charged by different firms;
- NFA's guideline concerning "up front" fees charged by CPOs and CTAs requires that such fees be fully disclosed before the customer invests;
- NFA Compliance Rules and Bylaws were amended to extend NFA's customer protection rules to the activities of NFA Members regarding foreign futures and option transactions; and
- NFA's proficiency testing program was improved with increased emphasis on the industry's ethical and regulatory requirements.

The toughest rules in the world, however, will not help protect customers if violations can routinely go undetected. NFA has added to its standard auditing and investigative procedures a new program using covert investigative techniques to learn firsthand what NFA Members are telling prospective customers over the telephone. Using phone numbers with out-of-state area codes and corresponding mailing addresses, NFA staff members have posed as prospective customers to receive telephone solicitations directly from Members. This highly successful program has been expanded by enlisting the assistance of state securities regulators from around the country and has produced a number of successful disciplinary actions.

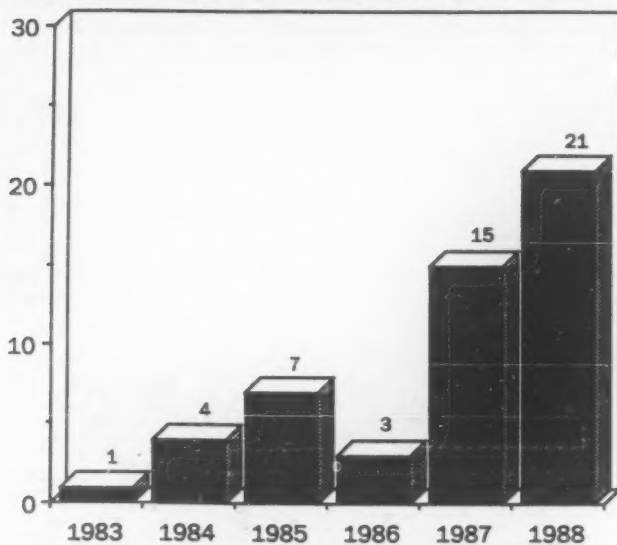
The adoption of these new rules and investigative programs has led to dramatic increases in all aspects of NFA's enforcement program. The overall number of disciplinary proceedings initiated by NFA's Regional Business Conduct Committees ballooned from 51 in NFA's first three years to 119 in the last three years. Moreover, the lion's share of that increase comes from cases involving telemarketing fraud or other forms of deception of customers.

EXECUTIVE SUMMARY

SALES PRACTICE COMPLAINTS ISSUED BY BCCs
From January 1, 1983 through December 31, 1988

The bottom line, of course, is not how many Complaints were issued but what types of sanctions were imposed. Once again, the numbers tell the story. The most severe sanction which NFA can impose is expulsion from membership since that effectively bars the firm or individual from the industry. In its first three years, NFA expelled 12 Members through disciplinary proceedings compared with 15 expulsions in 1987 alone and 21 more in 1988.

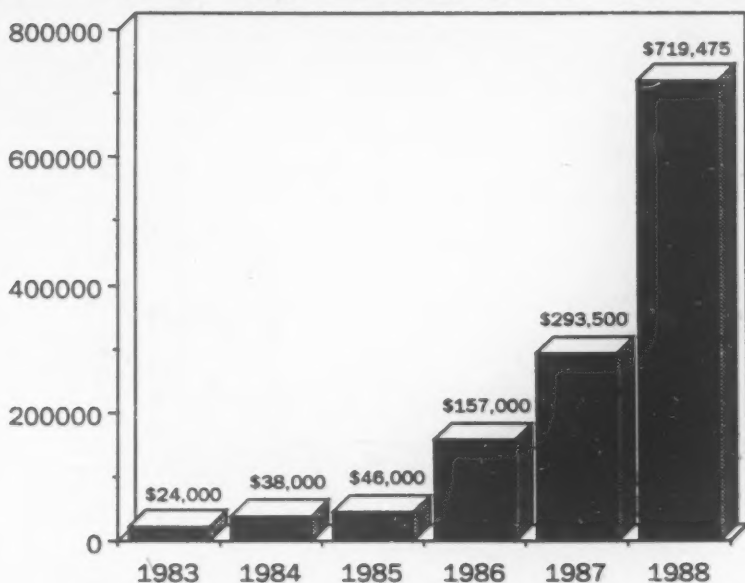
EXECUTIVE SUMMARY

EXPULSIONS ORDERED BY BCCs
From January 1, 1983 through December 31, 1988

Business Conduct Committees can also impose fines and have done so in record numbers over the last three years. In NFA's first three years combined, Business Conduct Committees imposed a total of \$108,000 in fines, a figure which was surpassed in each of the last three years. Fines in 1986 totalled \$157,000, almost doubled in 1987 to over \$293,000 and more than doubled in 1988 to over \$719,000.

EXECUTIVE SUMMARY

FINES LEVIED BY BCCs
From January 1, 1983 through December 31, 1988



Strong rules, thorough investigations and tough enforcement actions — all three have contributed to a successful enforcement program at NFA.

III. REGISTRATION AND MEMBERSHIP

One of the best ways to protect the public from unscrupulous firms and individuals is to keep those people out of the industry in the first place. That is the job that NFA has been handling since October 1, 1985, when it assumed responsibility for registration denial and revocation proceedings for all categories of registrants except floor brokers, leverage transaction merchants and their associated persons. Just as with enforcement matters, effectively screening out unethical individuals and firms in the registration process requires three basic components: specific legal criteria to determine registration fitness, a reliable screening process to identify the applicants who do not meet those criteria and effective proceedings to bar those persons from the industry.

The legal criteria used by NFA are those supplied by Congress. In 1982, Congress amended the Act to establish a two-tier system of disqualifications from registration. The more egregious disqualifications, such as prior revocations and certain types of felony convictions, are set forth in Section 8a(2) of the Act while Section 8a(3) sets forth less serious disqualifications, such as certain misdemeanor and felony convictions and

EXECUTIVE SUMMARY

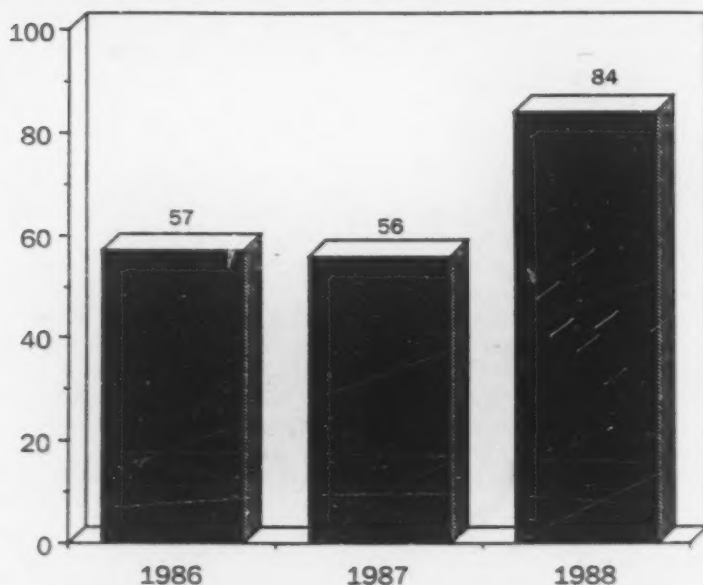
actions by self-regulatory bodies. Most of these statutory disqualifications provide very specific guidance. The needed flexibility comes from Section 8a(3)(M) of the Act which provides that registration may be denied or revoked for "other good cause." Over the last three years, NFA's Membership Committee has applied the "other good cause" standard and the other statutory disqualifications on a case-by-case basis and has developed a body of case law which has tightened and improved the registration screening function.

Though the legal criteria set forth in the Act set parameters for judging registration fitness, it is NFA's application review process which applies those criteria to the real world. All registration applications processed by NFA are subject to close scrutiny to determine whether the standards set by Congress have been met. Each application contains a series of questions which have been specifically designed to track the statutory disqualifications set out in the Act. Any "yes" answer to those questions will automatically bar the applicant from receiving a temporary license and will trigger an intensive review and possible denial proceeding by NFA. Of course, with regard to critical information such as an applicant's disciplinary history, NFA does not rely solely on the applicant's answers. NFA seeks independent corroboration of the disciplinary history information on each application by conducting an FBI fingerprint check and a review of CFTC and SEC disciplinary records. In addition, any material derogatory information received through NFA audits or investigations, from discharge notices from past employers or from any other source will be reviewed and, if appropriate, a denial proceeding will be initiated. Less critical information, such as employment and educational history data, must be verified by the applicant's sponsor. The sponsor must, at the risk of its own registration, sign a sworn statement that it has done so. NFA has recently taken steps to further supplement the sponsor's verification with its own spot-check of educational and employment information on randomly selected applications.

The ultimate proof of the thoroughness of the screening process is the number of denial or revocation proceedings which have been initiated. In the last three years, NFA has taken action in almost 200 cases to deny or revoke registrations. Furthermore, the 84 cases brought in 1988 represent a 50% increase over the previous year's total.

Not surprisingly, a disproportionate share of these cases involve a relative handful of sponsoring firms. In fact, just six sponsoring firms, .017% of NFA's membership, have been involved in 23% of the registration actions NFA has initiated. Five of those six firms have already been the subject of NFA disciplinary actions, three are now out of business and barred from the industry and two have been subject to substantial fines.

EXECUTIVE SUMMARY

**TOTAL NUMBER OF FITNESS ACTIONS INITIATED BY NFA
From January 1, 1986 through December 31, 1988**

In processing the thousands of applications which come in each year, it is just as important to process promptly the 99% of the applicants who are qualified as it is to screen out the 1% who are not. NFA has scored well on both counts. The processing time required to grant temporary licenses has steadily been reduced from an average of 8.7 days in 1986 to an average of 4.4 days in 1988. Furthermore, this 50% reduction in processing time was achieved at the same time that there was a 25% reduction in the Registration Department's staff, largely as the result of refinements that have been made to NFA's computer programs and capabilities.

IV. ARBITRATION

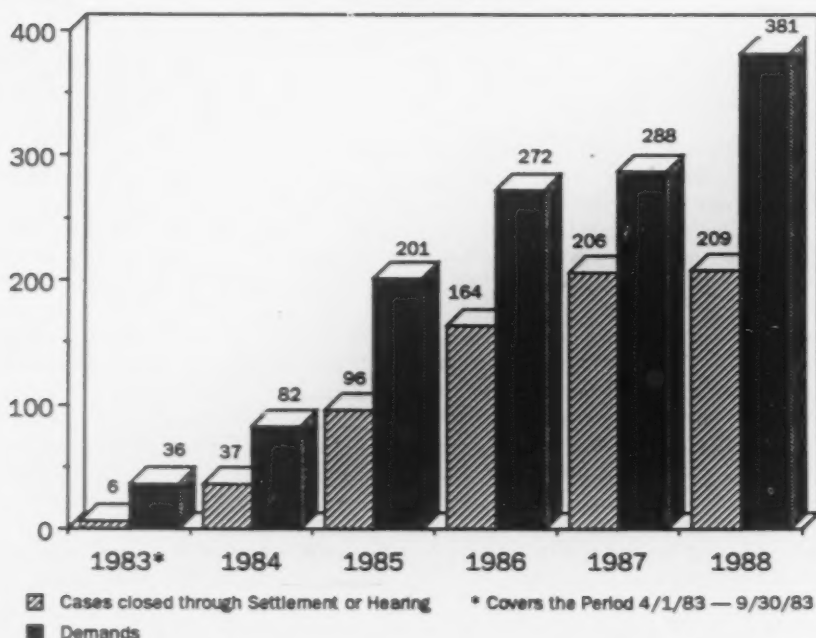
Congress has always recognized the value of arbitration as a means of resolving customer disputes in the futures industry. In fact, in 1974, when Congress first passed the enabling legislation which led to the creation of NFA, it specifically required any registered futures association to provide an arbitration program or an equivalent program as a condition of its registration.

In its first three years, NFA built from scratch an arbitration program which provides customers in the futures industry with precisely what Congress intended — an expeditious forum for the fair resolution of disputes. Rules were developed, procedures implemented and a nationwide pool of volunteer arbitrators was assembled.

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In the last three years, NFA has built on that foundation to continue to provide a high quality and inexpensive alternative to litigation. The dramatic growth of NFA's arbitration program is the clearest sign of its quality and its acceptance by the investing public it is designed to serve. In its first three years, the program received approximately 300 Demands for arbitration from customers. In the last three years, that number more than tripled with almost 1,000 Demands being filed. In fact, 1988 alone saw a 30% increase in filings over the previous year with almost 400 Demands filed. With the increase of cases filed there has been a corresponding increase in cases which have been concluded.

**DEMANDS AND COMPLETED CASES
By Operating Year**



With such exponential growth, of course, comes a great challenge — the challenge to maintain all of the advantages arbitration is intended to provide. NFA has met that challenge. In its last three years, the arbitration program at NFA has continued:

- to provide an inexpensive alternative to litigation. Despite the growth of the program, customer filing costs have remained modest.
- to provide a prompt resolution of disputes. NFA's arbitration cases are resolved in a fraction of the time consumed in litigation.

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- to provide a convenient forum for customers. NFA has maintained a pool of volunteer arbitrators in 48 states and continues to routinely provide customers with hearings in locations convenient to the customers.
- to provide an informal program. NFA's rules and procedures are designed to be simple enough that any customer can easily represent himself if he chooses to without becoming lost in a maze of legalistic maneuvering.

Most important of all, NFA has continued to provide a fair forum for the resolution of disputes. The statistics on recovery of funds by customers through NFA's arbitration program emphatically rebut any contention that customers do not get a fair and impartial hearing.

NFA has also responded to the challenge of growth by refining its rules, simplifying its procedures, expanding its jurisdiction and computerizing its docketing system.

V. CONSUMER EDUCATION AND ASSISTANCE

NFA recognizes that the best protection against investment fraud is a well informed consumer and has, therefore, always made consumer education one of its most important priorities. Throughout the last three years, NFA has continued to spread its message of consumer awareness through every available medium — by radio, television, film, seminars, printed materials and direct contact with members of the public.

That direct contact with the public occurs hundreds of times each week with the use of NFA's toll-free number. The highly trained staff in NFA's Information Center handled over 125,000 calls in 1988 alone, many from customers with questions about individuals or firms with whom they were considering doing business or with requests for NFA educational brochures. But the telephone is not the only way NFA reaches out and touches the public. NFA has continued to publish and distribute a wide variety of brochures concerning the futures industry and the steps which customers can take to ensure that their investment decisions are based on full and accurate information. NFA representatives have also continued to appear frequently on various radio and television programs focusing on customer protection and the futures industry. In 1989, NFA took this practice one step further and produced its own 14-minute film entitled *For the Investor's Protection*. The film provides basic information on how the futures industry functions and describes the services which NFA offers to the public. In all of these educational activities, NFA works closely with other groups and agencies such as the American Council on Consumer Interests, the National Association of Consumer Agency Administrators, the American Association of Retired Persons and the U.S. Office of Consumer Affairs.

VI. OTHER CUSTOMER PROTECTION SERVICES

Though the customer services and programs discussed above are NFA's primary responsibilities, they are certainly not its only ones. Repeatedly over the past three years, NFA has been called upon to take on additional responsibilities, and each time NFA has answered the call. These additional responsibilities and projects are detailed in this report

EXECUTIVE SUMMARY

and include the following activities:

- NFA has saved customers who were involved in a class action suit against a firm which had previously been expelled from NFA tens of thousands of dollars by serving as a court-appointed administrator of a \$5.3 million settlement fund. NFA was requested to administer the fund by the court and by the parties and agreed to do so since by recovering only its out-of-pocket expenses NFA could preserve more of the settlement fund for the customers involved;
- At the Commission's request, NFA performed a comprehensive study of the issue of FCM insolvencies, the protective measures already in place to guard against them and the feasibility of various additional protective and responsive mechanisms;
- NFA has continuously worked closely with federal and state law enforcement and regulatory officials to assist in any way possible with any futures-related investigations. For example, NFA meets on a quarterly basis with representatives of the FBI and the Postal Inspector's Office to review NFA disciplinary actions involving potential criminal violations. NFA's cooperation has resulted in a number of successful investigations and prosecutions;
- NFA has been an active participant in the Justice Department's Securities and Commodities Fraud Working Group. This group consists of federal and state prosecutors and regulators along with self-regulators from the securities and futures industries. The group meets quarterly to discuss issues involving techniques and regulatory coordination; and
- At the request of Congress, NFA assisted the Commission in conducting a survey regarding the leverage industry and the possible consequences of lifting the current moratoria on firms entering that business.

NFA performed each of these tasks without in any way diminishing its other ongoing customer protection programs. Furthermore, while increasing the scope and effectiveness of its regulatory activities over the last three years, NFA has actually reduced the cost paid for NFA services by the trading public which it serves. The NFA assessment fees for both futures and options trades have steadily decreased from 33¢ for futures and 20¢ for options when NFA began operations to a projected level of 20¢ for futures and 12¢ for options effective July 1, 1989.

VII. CONCLUSION

A periodic review by Congress of the effectiveness of the concept of self-regulation in the futures industry is both necessary and welcome. Ultimately, such a review can only benefit the industry, its regulators and, most importantly, the public we are all trying to serve. To be effective, that inquiry must focus on documented facts. NFA strongly believes that the documented facts concerning its record of accomplishment throughout its history have vindicated the confidence that Congress, the Commission and the industry have placed in it.

The CHAIRMAN. Thank you very much.

Let me ask this. Mr. Lind, you conducted a survey last April of, I believe, about 1,100 of Lind-Waldock's customers. You asked their attitudes about the Chicago probe, including this question: Do you think the exchanges do a satisfactory job of policing themselves? Now, 63 percent of those who answered—and I realize that that is not all of the people surveyed—but 63 percent of those who answered said no, the exchanges do not do a satisfactory job of policing themselves.

These are people who are generally active futures traders. You were not just going to the person on the street and asking them. It looks like there is an apparent lack of confidence in self-regulation. I ask you this—and then I'm going to ask Mr. Wilmouth for his reaction based on your last comment—how do you feel about the survey result?

Mr. LIND. Well, Senator, first of all, it was 4,500 people we surveyed of which we got somewhat over 1,100 responses. Naturally, I am not too happy about that response in that particular regard, although I think that my customer chooses us because we defend their interests.

One of the things that really has not come out very well throughout this whole proceeding, going back to when the subpoenas came out, as a start, is the fact that the FCM community takes its responsibility to protect its public customer very importantly. I mean, if I don't protect my customer, he is not going to stay with me. And that is true of the entire community. There isn't any FCM in the business that would knowingly give a customer to somebody he didn't think was an honorable broker. And that means it should be pretty hard for people who are dishonest to be able to be brokers for very long.

But naturally, that was one of the disturbing reports that we got, although that is sort of what I expected would be the result, especially at a time like this, because there is an inherent problem with fill quality, and it is because our markets are so efficient. We move on such small percentages of the total value of what we are trading, and we complain about something if it moves just two or three ticks away from where we expect it to be, and that is such an insignificant amount of money. For example, it may be on a currency contract, we will get a complaint if it moves \$37 from where the customer thought it should be filled, and the value of that contract is \$100,000. That just lends itself toward complaint.

But that is one of the reasons why we are successful, because we are so efficient. But naturally that does bother me. I would like to report also, though, that the vast majority of our customers—I'm sorry, I don't know if it was the vast majority, but a large percentage of our customers—also thought there should not be more government regulations. And the written comments that we got in that regard are because it is the exchanges that are the experts, and they are the ones that have to make the changes. But I think the exchanges are willing, and I think they have been. I think as time has gone on, the audit trail that there is today is the best in any industry of its type, and it is about to get a lot better.

The CHAIRMAN. Mr. Lind, would you say, though, having read the 1,100 surveys that came back to you out of the 4,500 that you

sent out, that there was a general feeling that there had to be improvements?

Mr. LIND. I didn't need a survey to tell me that. I have been fighting that for years. But I would like to make one other comment in that regard. Of the people who responded, 1 percent said that they stopped trading futures because of it, and 20 percent said that they would change the way they traded futures. And most of those people, most of that 20 percent, the way they changed is they changed the types of orders that they put in. But only 1 percent stopped trading because of what happened.

As a matter of fact, Senator, I will tell you that the Monday after the investigation was announced I think was the biggest day we had all year in opening new accounts. We can only assume that everyone decided the place must be clean now. But that is precisely what happened. I think it was the biggest day all year—I don't think that we have had a bigger day than we had the Monday after the subpoenas were announced.

The CHAIRMAN. Mr. Lind, do you think that, as a company, if your firm has been entrusted by a customer to execute orders and a floor broker cheats on that order, the firm should have to make that customer whole? I'm not talking here about punitive damage; I'm talking about actual damages.

Mr. LIND. Senator, the floor brokers we use are the best that we can find that are independent brokers because those are always the best—or almost always the best—brokers, and we can't afford to put our own people in on any kind of a substantial basis. They fill for numerous other firms. They may be filling for 10 or 12 firms.

The CHAIRMAN. But you chose that floor broker—it may be an independent floor broker—be it John Jones or Mary Smith, and John Jones or Mary Smith defrauds a customer, should you have to make the customer whole?

Mr. LIND. Well, first of all, I must tell you that if that type of fraud is such that it results in a fill that is of poor fill quality, then I do make that customer whole. In other words, if a broker gets an order at 8 in the morning, and the first time that the market trades at the price he fills it is at 8:25, whether he just blew it or whether he stole on it, I have to tell you that it is my responsibility, and I back that up to the reasonable price.

And we monitor that all the time. As a matter of fact we have a system at our firm where the last price is recorded—when the customer gives us the order, we record the last price. And when the fill comes back, if it looks like it may be somewhat irregular, we investigate it even before the customer asks us. Thirty-seven percent of our customers have found that to be the experience. That was also in the survey.

So what we are responsible for is a fair and accurate fill. It can't take too long; it has to be within reason. What we can't police, what is totally impossible to police and what you are asking us to be responsible for, is that example that I gave, and that I cannot afford to do. I can't police it. The only way it was uncovered after all this time was with undercover agents in the pit. Are you telling me I have to be responsible? That's an individual act by an individual person. He is an independent contractor. I can't be responsible for him. I can't stay in business and be responsible for him because

I have no idea what that liability is. And I monitor them. And I will tell you that every firm monitors their floor brokers, but if I have to be responsible—and I will tell you one other thing. If I think that somebody isn't giving us good fill quality, I move the deck. There is no question that that man is not going to fill for Lind-Waldock. And I think that that goes for every other brokerage firm in the business.

The CHAIRMAN. Thank you.

Mr. Wilmouth, were you surprised at all by that figure of 63 percent in the Lind-Waldock survey?

Mr. WILMOUTH. No, I am not. I think one of the biggest criticisms that we have as a self-regulatory body is the fox and the chicken coop idea. But let me just briefly go back.

In 1974, the Commodity Exchange Act provided for the establishment of a registered futures association, a self-regulatory body with designated responsibilities in the futures industry. It took the founding fathers of this organization, which I now head, from 1974 until literally the end of 1981, September 22, 1981, to agree on and receive CFTC approval of the articles of incorporation and the bylaws of the National Futures Association. In April, the spring of 1982, along with one of my other associates who is in the room today, Mrs. Tippins, we left the Board of Trade and were the first two permanent employees of NFA. We have grown to a staff of approximately 330 people; we have a budget of \$26 million. We have total responsibility for the registration of all commodity professionals in the business—FCM's, introducing brokers, pool operators, trading advisors, LTM's, and the 60,000 or so AP's. We also register floor brokers but have no ability to disqualify them or to reject them from the business.

We have extensive responsibilities—

Senator BOSCHWITZ. How many floor brokers?

Mr. WILMOUTH. Well, there are about 60,000 AP's; there are a couple thousand pool operators and trading advisors; almost 2,000 introducing brokers, about 7,500 floor brokers and about 350 Futures Commission merchants. We maintain extensive computer records on them. Anybody who is registered goes through an FBI fingerprint check and other provisions that we encompass in order to ensure that unqualified people do not get into the business.

We have a compliance staff, more than two-thirds of our people, who go out and who do financial audits and customer sales practice audits throughout the industry. We have an arbitration program that is immensely popular with people who deal in this business. I think if you look at our 3-year and our 6-year reports that have been submitted to the Senate, you will find that we have accomplished a lot.

I believe the CFTC, to whom we are directly responsible, believes that we have more than adequately done our job, and on our report card I am sure they would give us very high grades as I believe most Senators who have taken a look at that report would agree.

The one problem we do face is the "fox guarding the chicken coop" criticism. To me, the answer to that is relatively simple. It is in the best interest of the people in this industry to perform their self-regulatory tasks in the highest, most professional manner pos-

sible. If we don't, quite simply, we are going to go out of business. It is as simple and as easy as that.

The CHAIRMAN. And if you don't, then credibility suffers, and everything that people fear happening will happen; markets will go elsewhere, and we will lose a very unique part of American enterprise.

Mr. WILMOUTH. Right. And Senator, one more point. We don't believe that self-regulation is the end-all, be-all, as Senator Eagleton said.

The CHAIRMAN. I understand.

Mr. WILMOUTH. It is the first line of defense, backed up by oversight from the CFTC.

The CHAIRMAN. And this goes to the basic thrust of what we are discussing here.

Both Senator Lugar and I have to leave for other matters. I am going to pass the gavel to my friend from Alabama, Senator Heflin, and note that questioning will occur in this order: Senators Boschwitz, Heflin, and Gorton. I have to open the Senate at 10, and I will be back immediately thereafter.

So, Senator Boschwitz, please proceed.

Senator BOSCHWITZ. Mr. Chairman [Senator Heflin], Senator Gorton wants to ask just one question, and as I will stay throughout the entirety of the hearing, I will defer to him if I may, although your turn for questioning arises before his does. So why don't I just defer to him, and then you go forward, and then I will go.

Senator HEFLIN [presiding]. Go ahead. Let Senator Gorton go ahead.

Senator GORTON. In this morning's Washington Post, the chairman of the House Committee on Energy and Commerce, Congressman Dingell, is quoted as saying: "I see no reason for stock-index futures. I see them in the same place in the divine order of things as cockroaches."

The article analysis goes on to say that many people feel that stock-index futures contribute tremendously to the volatility, to last Friday, to Friday 2 years ago; that they don't represent an investment in anything except for large institutions making profits at the expense of one another or small shareholders; that they damage the true capital markets of the country by scaring out of a willingness to invest in capital small shareholders, people who want to hold shares in corporations but are afraid of the tremendous swings and volatility that are created by stock-index futures.

Is Congressman Dingell wrong, and why? What socially useful purpose is there in allowing stock-index futures sales at all?

Mr. DAMGARD. I would like to respond to that, and then I will let you go.

Senator GORTON. I want to hear from all of you.

Mr. DAMGARD. First of all, I think the smaller investor today is probably more apt to be invested in a pension fund or a mutual fund than with an individual account. It is those large institutions which are the ones that have found stock-index futures to be a very, very important investment management tool. And I think that one of the things that could conceivably change that chairman's mind, if in fact we see legislation to ban program trading, is

the fact that on October 19, 1987, one of the largest users of stock-index futures was the General Motors pension fund which had correctly concluded that the market looked awfully top-heavy and went short quite a number of stock-index futures contracts in lieu of selling the underlying stocks. They found the stock-index futures market to be quicker, more efficient and less expensive way to hedge the value of their portfolio, selling contracts in the S&P 500 to lock in the value of their portfolio at the higher value. When the market fell, they were able to sell the contract and essentially make a profit (in the futures) equal to the amount of money that was lost in the value of the stocks without incurring a taxable event by selling the stock in the first place.

Derivatives were correctly judged by both the Brady Committee and the White House task force as being very, very valuable management tools for fiduciaries and funds. If Mr. Binns, who runs the General Motors pension fund, could come testify before this committee, I think he could probably make a much more eloquent defense of stock-index futures than I can.

Mr. WILMOUTH. Senator, let me just add in support of what Mr. Damgard has said that I spent the first 25 years of my business career in the banking business. I was president of one of the largest banks with significant trust responsibilities in this country. And I must tell you that I don't look on stock-index futures as a cockroach; I think the banking industry looks upon it as an angel. It is an opportunity for them to hedge, to protect themselves against adverse changes that might occur in terms of interest rates or the portfolios that they hold for their customers and their trust department. It is an angel, not a cockroach.

Mr. LIND. I would like to add that I don't know how Congressman Dingell is going to react to this, but certainly, every stock exchange is now coming up with products to copy stock-index futures. I don't think you can condemn one and condone the other. The New York Stock Exchange has come up with its basket, and I don't know whether they have started yet, but they are certainly on their way.

Basically, I sort of thought the CFTC should have to be in charge of that because it looked more like a future to me than it did any type of stock investment.

But the reason for the break has nothing to do with stock-index futures. It has to do with the speed of communication, the computer, and primarily the fact that so much of the money that gets invested in the stock market is held in the hands of relatively few people. And that, we are not going to change. We can't go back to the fifties and sixties and look at investment in the same regard as it happens today.

The flow of information to everybody is so much better, and the difference between knowing and not knowing a vital piece of information has now gotten down to seconds. And when you have speed of information of that nature, you are going to get violent swings.

Mr. ISAACSON. Just one quick comment. We, the commodity trading advisors and pool operators, are the mutual funds of the futures industry. And I think if we didn't offer our clients the opportunity to trade in stock-index futures or whatever, we would be at a disadvantage to other markets. Our clients ask for that.

Mr. LIND. I would also like to add that my retail client base, from what we have been able to discover, uses the S&P's as a hedge itself. If they are afraid of something, they will sell a certain portion of their portfolio. And one of the reasons why we are led to believe this is because if it was a trading vehicle or a speculative vehicle, they would just go into one of the various stock index markets that there are. But we will see a combination based on the value of their portfolio. They may have one from the New York Futures Exchange, one from the S&P which will total something that we make the assumption that that's the amount they want to hedge in their portfolio.

Mr. DAMGARD. I'm sure that the reason that Aetna, Kemper, and Equitable have joined my organization is because they see stock-index futures as a very, very valuable management tool that is good for hedging the value of their portfolio—and they are not for everybody, Senator. It is a very sophisticated market. Alluding to what Senator Leahy said earlier, we do have a real serious perception problem. One of the things that I think is helping is the fact that financial institutions are becoming larger and larger users of our markets.

Senator GORTON. Thank you all for your answers, and thank you for letting me go out-of-turn.

Senator BOSCHWITZ. So why does Congressman Dingell say that?

Mr. DAMGARD. I really think that Congressman Dingell believes very sincerely that the existence of a derivative market is unsettling to the cash market. We believe that he is wrong. And then there are others who are more jaded than I am who would believe that Congressman Dingell's real belief in saying not very nice things about the CFTC and some of the instruments that they regulate is to increase his domain on the House side and indeed bring under—

Senator GORTON. Some people would say that.

Mr. DAMGARD. Yes. I can't imagine who would say those things, but I have heard those rumors.

Senator BOSCHWITZ. Is it perhaps because he feels that the trading in this nature of futures adds to the volatility of the market?

Mr. DAMGARD. I believe so.

Senator BOSCHWITZ. That it accelerates the volatility once it begins; would you comment on that?

Mr. DAMGARD. Well, I'm not an economist, but I think we may have more work to do certainly with Congressman Dingell in terms of education.

Senator BOSCHWITZ. Once the market changes begin, does it accelerate the volatility?

Mr. DAMGARD. I don't know the answer to that. I think it probably could. On the other hand, nobody seems to give index arbitrage any credit when it acts as a stabilizing force. I do think that when people decide they are going to sell, they will sell in the quickest, most efficient way that they can sell. I think Barry Lind is absolutely right; there are a lot of fund managers and there is a tremendous concentration of selling power in the hands of relatively few people. When these fund managers begin to sell, they are going to use futures as well as the cash.

I noticed when the Merc hit their so-called circuit breaker, lots of that selling pressure went back to the stock exchange, and then when stocks and futures got out of balance, the institutions were in there buying the futures contracts, which many will credit for having reversed the 190 point loss and moved the market back up 80 some-odd points the following day.

The problem in 1987 was that the institutions were no longer able to use index arbitrage, and thus they continued to sell in the stock market at a time when they might very well have been buying the future and conceivably could have halted the 500-point drop at, say, 150 or 200.

Senator BOSCHWITZ. Bob, would you also—or any one of you—comment about whether or not the volatility of the market is accentuated or exacerbated due to the presence of this particular trading of this index?

Mr. WILMOUTH. I think that's a hard question to answer, but I think Barry Lind hit the nail on the head. One of the things that I think we all have to bear in mind is if you go back a decade or two decades ago, or back into the fifties, the marketplace was totally different. We didn't have stock market index contracts 10 years ago. The institutional investors weren't as important as they are today. You didn't have program trading with computers which are able to make these massive decisions and move stocks back and forth massively. We didn't have a stock market index.

We have to begin to look at the marketplace in a different way. Yes, it probably does cause some volatility, but I don't think that you necessarily ban it automatically. I think you study it and you begin to understand it.

And I must tell you that I think stock market index contracts would not succeed to the extent that they have if there wasn't a commercial need or use for them, as John Damgard has pointed out, and as I would tell you is true in most financial institutions.

Senator GORTON. The criticism isn't so much that they don't benefit these large institutions; it is that they have exacerbated or accelerated exactly the trend you set—individuals, people who simply want to own shares out, because they are the victims of the success of this—

Mr. LIND. But Senator, I don't think there are any people or very many people who use stock-index futures as a replacement for the stock market. No one goes in and decides they want to buy S&P futures instead of buying stocks. That isn't what S&P futures are used for virtually by anybody.

Mr. DAMGARD. Actually, the little guy really has his money in the mutual funds and pension funds. To the extent that those institutions benefit, they are benefiting the shareholders in that mutual fund; to disadvantage the mutual fund is to disadvantage the little guy at the expense of a John Klugie or someone. It is the very, very wealthy individual investor today who gets the attention of his individual broker, in my judgment.

Mr. WILMOUTH. And changes have been made. If I remember correctly, after the last upheaval in the markets back in October of 1987, the DOT system, the order entry system of the New York Stock Exchange, has been changed so that when you reach a certain number of shares of stock that are being traded, the individual

investor with less than I think it is 2,000 shares of stock gets in ahead of the big program trades. So changes are being made to reduce the volatility to the extent possible. But there are new instruments, they have to be studied for a long period of time, particularly if they serve a very worthwhile purpose, which I think, Senator, you agree they do.

Mr. LIND. I think the reason for the circuit breakers after the crash in 1987 was just that. The volatility of whichever side is going down faster, we wanted to slow it down so they could get back into proportion. I think there was no question that they certainly worked on Friday, and they worked very well on Monday. But the basic theory—first of all, I would like to comment on Friday, when stock-index futures went down to their limit, which was when the Dow was about 90 lower. That did absolutely nothing to help the Dow from going down. It just kept continuing to fall. I think it was almost 200 lower when stock-index futures reopened a half-hour later—it wasn't 200 lower, but it just continued. It never rallied. So it certainly didn't adversely affect it.

But there are many mutual funds, pension funds, that want to sell blocks of stock that don't necessarily parallel the S&P's or the Dow; they just want to get out of certain stock. And the way that they can do that is through the arbitrageur, who is willing to maybe add a few stocks to that and then do the rest in stock-index futures. So instead of the pressure coming on a few stocks, the pressure may be absorbed more by the entire market, and that is part of the theory, and that is part of what has made the markets relatively liquid, and that is part of what makes stock-index futures work as an aid to the stock market.

Senator BOSCHWITZ. A final element to that question, and that is in the event that we were not to trade them, would others thereupon trade them and other exchanges, be it in London or Tokyo—

Mr. LIND. They are waiting. Senator, they are waiting. I remember when all this happened, it looked to me like London was just sitting there, hoping that we would ban it, because they would open it the next day.

Mr. DAMGARD. And Tokyo and Osaka exchanges have them up and trading right now.

Mr. WILMOUTH. They are doing the same thing with Treasury bond futures. They are going to compete actively and aggressively against the Chicago Board of Trade in Treasury bond futures. We have developed markets, and they go after them, it seems.

Mr. DAMGARD. It is a global market, and that is another reason why we see more volatility. I don't think it can be pinpointed on any one particular instrument. We have satellites, and communication is so much quicker than it used to be that everybody can receive information and transmit their orders very, very quickly.

Senator BOSCHWITZ. Mr. Chairman, before we proceed, I feel that I owe an apology to this panel and the preceding panels. I had a breakfast with Mr. Greenspan, or I would have been here for the preceding panels. But I am sorry to keep you guys all overnight because of my rather extensive series of questions of yesterday—which I probably will start up again with this panel, Mr. Chairman—

[Laughter.]

Senator HEFLIN. How about apologies to the other members of the committee?

Senator GORTON. I have already discussed that with him.

Senator BOSCHWITZ. I apologize.

Senator HEFLIN. Let me ask you a few questions. One of the issues that will be confronting us is service fees. This seems to be a controversial issue. In the event that these provisions are adopted, the cost of monitoring trading floors and insurance compliances by the exchanges—what is your position on service fees, and how can it be financed if service fees are not used?

Mr. WILMOUTH. Senator, let me try and take a crack at that if I can. I think the concern that all of us in our industry express about the current bill—it may be unwarranted because I have seen statements from the staff, and I have talked to the staff about a clear interpretation of what is in there with respect to service fees. But unfortunately, we believe that the current language in the bill is so broad that literally, the entire expense of the CFTC's budget could be borne by the trading public and the industry. And as you know, the industry already bears a significant portion of cost through all of their development expenses in terms of coming up with the best possible products to protect the investing public. NFA gets 80 percent of its \$26 million budget, approximately, from service fees on the public.

But I think it was made relatively clear in the session yesterday afternoon that what the bill is really talking about is taking the baseline of the CFTC's budget, moving it up every year to where it would normally be, and then the expenses that are incurred over and above that in order to do additional surveillance on the floor would be the cost that you would want passed on in terms of service charges.

I don't think that was relatively clear to any of us until the session in the afternoon—although I must admit in all honesty that in my conversations with Ken Ackerman, for example, that that is the way I have understood it and that is the way we believe it.

I think the industry is willing to bear its fair share of cost as we do with NFA. We have taken over from the CFTC an enormous amount of responsibilities in terms of compliance activities on a huge segment of the population in the futures industry and by doing registration activities. But we want to make certain that it is very clear just what those narrow additional expenses are that we are picking up, and I think yesterday's session helped to clarify that.

Senator HEFLIN. Would anybody else like to comment?

Mr. LIND. Well, this issue is too political for me in reality, but from what I just heard, if you are talking about the exchanges or the public paying for surveillance on the floor—I mean, if there are going to be people around to monitor what is going on on the floor—then it is no longer a political issue; now it is an issue that affects my customers, and I would be most in favor of that.

I think that if you are talking about the types of sums that would be reasonable, I think the exchanges can certainly afford to pay for that. I wouldn't like to see my customers pay for it, al-

though they pay for it indirectly in the clearing fees that they pay the exchanges in that regard.

On that basis, I would like the payment of that to come from the exchanges, and if they have to raise clearing fees, then they'll get the income in that regard.

But I certainly would be in favor of that type of surveillance. I would also be in favor of camera surveillance on the floor.

Mr. DAMGARD. Some of the arguments here, Senator, relate to just exactly how these fees should be assessed, and on the theory that the public customer and the FCM's are essentially supporting the NFA to the tune of, what, 90 percent, there has been an expression that if the additional costs involved for the CFTC are indeed to monitor activities of the floor trader that perhaps these new fees should be, as Barry suggested, borne by the floor community and the exchange.

I think that in theory, that may make sense. On the other hand, a significant number of the traders on the floor, as I understand it, are called "scalpers", who are in there, adding liquidity by taking a tick here and a tick there. And if any kind of meaningful fee were assessed to the scalper, it is possible that the scalper wouldn't be able to scalp anymore, and therefore we have to know just exactly how much liquidity the market would lose. In that context, I think perhaps a study, which others have suggested and I think is even part of the House bill, might be a better solution rather than just taking an arbitrary amount now to attempt to alleviate the burden.

Mr. ISAACSON. I think that probably commodity trading advisors and pool operators represent anywhere from 20 to 50 percent of the retail business on the floor, and by and large we don't have any problem with the executions. We don't want any extra fees. We are happy with what the NFA is doing, and we feel that the problems on the floor, the indictments, were just a minority, a small portion of the people who were down there.

Senator HEFLIN. Let me ask you about the audit trail technology. The futures industry has committed itself to developing this technology. Of course, as I understand it, it is probably going to take 3 years to anticipate developing it. What type of monitoring role should the CFTC play in that development to determine whether it can be effective and to have input relative to the development of the technology?

Mr. WILMOUTH. I think again, listening to the conversations yesterday and the testimony yesterday, that total, 100 percent verification on an audit trail basis is something that may be almost impossible to achieve. The exchanges, particularly the two largest ones, as we heard yesterday, have committed at least \$5 million to the development of some hand-held terminals and some way to get better verification and a better audit trail.

The concern that I think everybody in the industry expresses is that this is new technology, it is being developed, and we are just not certain how fast and how soon it can be developed.

What we have said, I believe, and what we would like to see accomplished is that as we begin to develop this technology that there be some check points on us; that at the end of a year or 2 years or whatever the period is, the exchanges report probably to

the CFTC—I think someone also mentioned the GAO—who keeps track of what is going on and does not try to force us into an impossible position of trying to achieve something that may be technologically impossible in view of the type of business that we have. But I think we are perfectly willing in the industry to support the development, gradually, of a system that will give everyone 100 percent confidence in an audit trail.

Mr. DAMGARD. We have long believed at the FIA that an enhanced audit trail is the answer to many of the problems that have surfaced over the last 6 months. We fully believe that an enhanced audit trail combined with some sort of surreptitious surveillance will act as a necessary deterrent to prevent any further fraud from occurring as it did before on the floors of the exchange.

We would point out, as an earlier witness did, that we are unaware of whether or not GAO visited any of the brokerage houses in their efforts to come up with a report to this committee. The exchanges I think made fairly eloquent arguments when they were on about the difficulty in meeting all these audit trail standards, particularly the four separate time stamps.

The "independent, precise and complete" language that is in the bill needs clarification from the standpoint of whether or not a brokerage firm that has a broker employee on the floor who receives an order standing in his booth can time stamp the order himself, if it is the exchange's time stamp, and meet the test that the time is "independently" recorded. Do we have to have an exchange employee standing next to the brokerage employee to time stamp the order on arrival? I think a lot of these problems will go away in the 2 or 3 years that it is going to take to develop a hand-held terminal. During that period, I think the CFTC will have to take a very active role in working with the exchanges to make sure that we get through this period so that there are no other "black eyes" suffered by the industry.

Mr. LIND. I would like to add, if I may, that the biggest problem with audit trail isn't when did the order get filled. In reality, we know today very well what time the order was filled, and we know that independently because there is a time and sales recordation of that, and that the audit program is very good at telling us this. I mean, we may have two choices, but they are not that far apart. But the problem is why do they get filled at that particular moment. Why didn't it get filled sooner? Why didn't it get filled later? It should never be later, but sometimes it looks funny in that regard.

We don't need a time stamp after a broker fills an order. That is definitely going to slow down the system; that could break the system. In an active market, a broker may fill 15 orders with one open outcry shout. He may have 100 cards to buy off 15 different orders, and he bids it for a price, and someone says "Sold"; he can't go stamp those 15 orders. And the pit is not big enough for us to have someone take them from him, because then he's got to get them back, and what if an order gets lost? There are a lot of problems. But that isn't necessary, that's not what we need.

The biggest question that we have is when did he get the order. That's what our problem is today. What exact moment in time did the broker get the order? That's the key ingredient to a better

audit trail. That is what will solve, as far as I'm concerned, all of the problems, because that takes this window—right now, we have this window—if I get an order at 8 in the morning on the floor, I don't know whether it is 8:01 and 30 seconds, or 8:01 and 20 seconds—I don't know exactly when it got into the broker's hands. I have to give it to a runner; he's got to take it to a clerk; the clerk has got to give it to the broker; he may be busy——

Senator BOSCHWITZ. But there is a stamping requirement now, as I understand it.

Mr. LIND. There is a stamping requirement. When I get that order at exactly 8, I stamp it. The next stamping requirement is when it gets back to my desk.

Senator HEFLIN. Well, how do you enforce it?

Mr. LIND. I don't understand that, Senator.

Senator HEFLIN. You say that that's a problem. If it is a problem and they don't stamp it, or they don't do it, how do you——

Mr. LIND. No, no, no. It is done. The problem is—I'm not making myself clear, obviously—the problem is that the window that we have—what we need to get a better idea of is exactly when the broker got the order, because we don't know how long it takes from my desk on the floor to get into the broker's hands from the time it leaves there. If we solve that, then we will have solved the major problem to the audit trail, because then I will be able to tell you within 20 or 30 seconds of when that order should be filled. And that is precisely what the exchanges endeavor is going to be part of this whole audit program, and they have been working on one for several years.

The CHAIRMAN [presiding]. Weren't they doing some research on hand-held technology even before the Chicago indictments, or anything else, came out?

Mr. LIND. Right. This is bringing the computer into the pit with open outcry, where we will have an exact knowledge of when the order got to the pit. In that regard, when they started this, the hand-held operation of this was out of the question. And they are still talking about taking it into the pit with a firmly implanted station. But of all the things that the exchange has been doing, of any of the things that this committee has asked, as far as I am concerned for my customer, for the benefit of my customer, so I can tell exactly what is going on, there is nothing more important than my getting the idea of exactly when that broker got the order. Once I know that, we have cut the window down so substantially that I think the very, very vast majority of our problems are solved.

Senator HEFLIN. Well, stamping doesn't work on it or what? I don't understand how you're going to do it.

Senator BOSCHWITZ. Would you yield for just a moment?

Senator HEFLIN. I was trying to get a question answered.

Senator BOSCHWITZ. Fine. Pardon me.

Mr. LIND. The way the exchanges have programmed this—and I have seen this, I have been a part of this—is that there will be a broker station. Instead of my runner running the order in by hand, on paper, into the pit, I will be able to send my order directly to the broker in the pit via computer. It will independently, then,

record the exact moment that it appeared in his deck. From that point in time, it should not be very long before that order is filled.

Right now, the way it works, when I take it by hand to the broker, it is liable to be 30 seconds, it is liable to be 2½ minutes before he fills that order. I would like to get that down to where it is 20-30 seconds, and this does it.

Senator HEFLIN. The computer aspect of it.

Mr. LIND. The computer aspect of it, yes.

Senator HEFLIN. I yield now.

Senator BOSCHWITZ. I thank the Senator.

You have me a little confused, Mr. Lind, by talking about a broker at a desk and using that term interchangeably with the guy in the pit.

Mr. LIND. Yes, that's the issue, I think.

Senator BOSCHWITZ. Let me try to draw out—I'm not quite sure where you are sitting, but I gather that you, Mr. Lind, are sitting elsewhere, and you call the broker, who has a phone near the floor, and that broker signals to the guy who is in the pit, and it is your call to the broker who then signals the guy in the pit. You want a stamp there; is that correct? Am I expressing that accurately?

Mr. LIND. He is talking about an arbed order, a hand-flashed order. We're not talking about that.

Senator BOSCHWITZ. Would you describe that, Mr. Wilmouth?

Mr. WILMOUTH. Yes, if I may, I think where the confusion is—Mr. Lind is the largest discount futures broker in the world, if I understand correctly. Orders flow into Barry's office from customers anywhere in the world, for that matter—

Senator BOSCHWITZ. Mr. Lind's office is a building removed from the floor.

Mr. WILMOUTH. He is removed from the floor, that's right. What he is talking about is he has to bring that order to the floor—

Senator BOSCHWITZ. By phone.

Mr. WILMOUTH [continuing]. Yes, by phone or by messenger, any way he wants to—but when it gets down there, it goes to a desk that Mr. Lind controls; and from there it goes to somebody in the pit—

Mr. DAMGARD. Either flashed or run.

Mr. WILMOUTH [continuing]. Either flashed or run—who has got to fill that order. And Barry wants to know when it gets to that guy or gal who is going to fill that order for him, and that's the most important thing to him in terms of getting a time stamp. I think that probably clarifies it.

Mr. LIND. That is the only thing that we need to know.

Senator BOSCHWITZ. I see. I thought that the time stamp that you were looking for was the guy on the floor, not in the pit. Am I mistaken in that; is that correct?

Mr. LIND. Right.

Senator BOSCHWITZ. But as I understand, does this bill require the pit trader—and let's call him that for a moment rather than a broker—the pit trader to record when he receives the order or when he fills the order? I thought it was the latter.

Mr. WILMOUTH. Both, both times.

Mr. LIND. It is both; when he gets it and right after he fills it.

Mr. DAMGARD. By an independent source. That's the key.

Senator BOSCHWITZ. Well, an independent source could be the hand-held computer; is that correct—

Mr. DAMGARD. Correct.

Senator BOSCHWITZ [continuing]. In the event that one is developed.

Mr. DAMGARD. Correct. In 3 years or whatever, the hand-held computer is going to do away with a lot of these concerns. But right now—

Senator BOSCHWITZ. It has not yet been developed.

Mr. DAMGARD. Exactly.

Mr. LIND. No, I beg to differ, if you're done. A broker—the trader who fills the order will not have time after he has filled the order, on a hand-held basis, to mark down or record all of the orders that he has filled. A good broker—

Senator BOSCHWITZ. That's because a pit trader may fill 15 at once is what you're saying.

Mr. LIND. Right. And he also has to keep looking at what is coming up. I mean, good brokers are getting orders all the time.

Senator BOSCHWITZ. But he has a card now, and he has to fill in that card, does he not?

Mr. WILMOUTH. Yes, but he fills it in frequently after he's done. I have seen the development, because I have worked with some people, of a hand-held device which is about the size of the remote control device on your television. It works by sending infrared signals to the master computer of the exchange. What they are trying to do is build into that little hand-held device certain things. You will build in the actual commodity because you'll be in one pit; you could build in the time; you could build in other things.

What they are hoping to do is to just have three touches that you have to make. One would be quantity—I am going to buy five or sell five—one would be price, and you could just use the tick, and that's all you really would need since the master boards would control the ticks; and then finally, you would need the identification of the opposite broker.

The problem that we see—or at least I should say that I see in this—is that I had watched for the 5 years I was president of the Board of Trade actions where a broker has 150 to fill, it is the last minute before the market is going to close, and he does 5 with Sam and 4 with Harry and 20 with Pete and so forth and so on. And what you're going to do, unfortunately, even with the most advanced hand-held terminal that I think is possible in the mind of man today is you are going to slow that process down. And if you slow the process down, then you may not have the liquidity which makes these markets as excellent as they are.

The CHAIRMAN. Well, when you do it now, you have to write something down.

Mr. WILMOUTH. But what you do now, Senator—and I must admit that it is not 100 percent accurate to the exact minute—but what you do now is you fill 5 and 20 and 10 and 30 and 40, and then when you've done it—you know who you have done it with; these are experienced people in the pits—then they write down—I did five at a sixteenth with 295 or 432 or "Sam"—they even put down identifications by name. And that is the real problem that we see and why I think—

The CHAIRMAN. How long does it take a broker to write that down?

Mr. WILMOUTH. Well, if he is trading near the close of the market, and he writes it after the close of the market, it probably takes him a minute or so to write all the trades down. You are bound to slow trading down, and what we have to do is work over a period of time to get the system such that you can record trades as fast as possible. They are not talking about depressing buttons, now; they are talking about a touch system where you just touch some things, and that is going to speed it up. But it needs development, and it's going to take a lot of money and a lot of time to do it.

The CHAIRMAN. But what you're saying is that you don't think, at least based on what you've seen today, that it could be done as quickly as the writing.

Mr. WILMOUTH. I don't think so; I really don't, in the busy, heavy markets. If you go into some markets where you're not as busy, sure you can do it. But you go into the Treasury bond pit or the S&P 500—no.

The CHAIRMAN. Especially last week.

Mr. WILMOUTH. Yes, sir.

The CHAIRMAN. What is the longest that you might go before a trade is written down today? Take a day like last Friday, where the S&P market was obviously moving very, very rapidly. What do you think would be the longest one might take to write these trades down?

Mr. WILMOUTH. It depends upon how fast the trader is and how active he is. And I've never been a trader. I've done plenty of observations, and Barry may be better-qualified to answer this question than I am. But it seems to me that most of them that are spreading their orders out by doing 20, 40 or 50 with each person, as soon as they've done it—and they've probably done it in a matter of 30 seconds or less—then take the time to write down the trade, then go right back and do some more. It is not a long period of time.

Senator BOSCHWITZ. There is a 1-minute rule suggested in this bill, and that is a rule that the exchanges feel they can comply with, as I understand it.

Mr. WILMOUTH. Yes, I think that's correct.

Mr. LIND. Which 1-minute rule are you talking about? After the filling of the order?

Senator BOSCHWITZ. Yes.

Mr. LIND. I can't speak for the exchanges by any means, but I cannot conceive of how a broker at all times is going to be able to—

Mr. WILMOUTH. That's the key—at all times.

Mr. LIND [continuing]. Endorse that. I mean, when a market is busy, the important thing is to get the order filled. And as soon as he fills that order, he has to probably go on to the next order. And he isn't going to endorse these orders until he gets enough time to where it quiets down or until he can turn his deck over to somebody else that is part of his association so he can go and endorse all that paper. And there is no physical way that I believe, without breaking the system, that you can force someone to endorse it within a minute.

But let me go back for a moment to what the exchange is in the process of developing that will solve that problem.

Senator BOSCHWITZ. Yes.

Mr. LIND. On this broker station that is being worked out that will be in the pit where I will be able to send my order directly from my office into the filling broker in the pit. That will give us the record of when he got it, exactly to the second.

Senator BOSCHWITZ. There is now a step in between that; is that correct?

Mr. LIND. Right now, the way it works is I send that order to the floor of the exchange to a desk that I have; I record that at my desk when I get that order; then I have to run it into the pit, and that's what makes for this period of time that we don't know when an order got filled.

Senator BOSCHWITZ. And it is your hope that there will be a computer that you will be able to go from your office right to the pit.

Mr. LIND. It's more than a hope. We believe—

Senator BOSCHWITZ. That's what you would like.

Mr. LIND [continuing]. That the exchange has that developed—maybe not be able to do it on a hand-held basis, but it has been developed to the extent certainly that we will be able to have this in the pit—I don't know how long it will take, but I don't think it is all that far away—anyway, that gives you the time that the broker actually received it in his deck.

Now, we were just talking about after he fills the order how it is virtually impossible for him if it is still busy to endorse 15 pieces of paper that he may have had there for a half-hour and finally got to his price, which is going to take more than a minute to endorse anyway. But with this computer in the deck, what he can do now is if he has 50 cards, let's say, to buy at a price of 12, when he buys those 50 cards, he erases it out of his computer. And what that will do is that will send a signal to me, the brokerage firm, that that order is filled, and it will send a signal to audits to what time that trade actually took place. That will far exceed the benefits of any individual hand-held time stamp that any broker could possibly use—at least as I can see it.

Senator BOSCHWITZ. For the sake of my colleagues, and I would like to ask you for my own edification as well—one of the more interesting elements of yesterday's testimony was Mr. Mahlmann, who pointed out that on Sunday night, 285,000 trades took place on the Chicago Board of Trade I believe in Treasurys. They took place over a 3½ hour period, and I figured out how many trades it was per broker and so forth, and Mr. Mahlmann said, now, hold on a minute—there's a great concentration of trades particularly at the outset, and there is no perceivable way that simultaneously, when 50 or 100 trades are taking place, that thus far a computer hasn't been developed that could handle it. And that was the first time any international markets were opened after the Friday drop of 190 points.

Would you comment on that, that great array of orders that took place, and whether or not that seems to be one of the sticking points with respect to the computers?

Mr. WILMOUTH. Well, if you noticed in the Washington Post this morning, the Chicago Board of Trade has a full-page advertisement which talks about the volume that did occur on that evening.

I think what we have to clarify is the fact that I believe Mr. Mahlmann was talking about actual volume in the 285,000 contracts. That doesn't necessarily mean that there were 285,000 trades. But I think his point is a valid one in that some of those trades, probably the biggest bunch of them, occurred right at the opening, because people had Friday night, all day Saturday and all day Sunday up until the opening at, I believe, 5:30 in the afternoon to decide what they wanted to do. So there were a bunch of opening orders that came in at that time.

I was not present, and I have not discussed it with Mr. Mahlmann's associates, but my belief is very strong that a number of that 285,000 volume came in right at the opening, and every broker was trying to get a fill at the very same time, and that's the issue that I think he was referring to, and I think it is a very valid issue. But it wasn't 285,000 trades; it was 285,000 contracts which could have been—you know, one trade could have been for 10 Treasury bonds or 20 or 50 or something like that. But the main point is that you bring all of those in at one time, the bell clangs, the market opens, and everybody is bidding for the same thing, literally, and some of those are being done at the same time, and they are being marked down manually. And the computer would have a very difficult time, I believe his contention was, to try and fill those at the same time. And I think he is right.

Senator BOSCHWITZ. Let me turn to another issue, and that is the issue of dual trading. That seems to be an issue that Senator Lugar at some length asks what can be the philosophical justification for dual trading. I noted Mr. Melamed's answer was very interesting, that dual trading takes place throughout all industry. And I noted that my father, who was a stockbroker, by that definition would have been a dual trader because he traded for himself as well as for his customers, and that people I dealt with in the purchase of lumber and plywood were dual traders because they bought for their own accounts and speculated on the market and then sold to me.

Most of you have touched upon it in your testimony. Do you feel strongly that dual trading is something that needs to be continued for liquidity in the markets and so forth?

Mr. WILMOUTH. Yes, Senator, I feel very strongly that it should be, and let me give you the reasons why. I think first of all that a broker who is a dual trader is a far more knowledgeable broker than somebody who is just sitting there, filling orders. After all, he is filling orders for himself, and he is very cognizant of what is going on in the market, and I think he can do a better job. So, although I am not allowed to participate in the futures markets because of my position, if I did I would rather deal with a dual trader.

And I think that a number of surveys have been done internally by some large FCM firms which indicate that a number of their customers want the dual trader to fill their orders.

The only thing we have to assure—and we are willing to assure—is that we can verify the activities of a dual trader. And if

you can verify his activities so that you know what he is doing, then you shouldn't have any concern about allowing dual trading.

The second point I would like to make is that in a lot of the small, illiquid contracts—and I have not, incidentally, seen the CFTC study—but it would still be my belief that it would be very difficult to get some contracts going if you didn't have some traders who are dual traders go in there and speculate on that contract and be willing to supply volume and thereby liquidity to that marketplace.

The CHAIRMAN. Excuse me. It is obvious that we will not finish this hearing this morning. I know that the people who are waiting to testify have other things that they may well be wanting to do. We will reconvene at 7 a.m. tomorrow morning and try to start earlier so that we can finish. If this panel does not finish today, we will bring them in at 6 tomorrow morning. I know that you are all busy people, and I know you want to get finished, so we will do the last panel at 7 a.m. tomorrow morning. If they would like to start earlier, that's perfectly all right with me. I will be here at 5:30 under any circumstances and would be glad to start at that time. But for the convenience of some of the staff, I was placing it later.

Senator BOSCHWITZ. Mr. Chairman, I don't think we're going to go on much longer—at least I will not——

The CHAIRMAN. That's all right. We have to leave for the——

Senator BOSCHWITZ. Oh, you are going to go for the President of Korea?

The CHAIRMAN. Well, we were going to stop at 10. We should have started earlier this morning, but that's not the Senator's fault. Take as long as you want.

Senator BOSCHWITZ. Well, are you going to go to the joint session to hear the President of Korea?

The CHAIRMAN. A number of people will. Let us continue on with this panel, but the last panel we will do at 7 in the morning.

Senator BOSCHWITZ. Well, I am happy to come back at 7 in the morning, Mr. Chairman. I think I have an 8 or 8:30 breakfast, so that that would fit in quite well.

The CHAIRMAN. I doubt if we would get done by then. Maybe we should make it 6:30.

Senator BOSCHWITZ. I think that we can just proceed with this panel——

The CHAIRMAN. I am not trying to cut it off, but we are not going to have time to get to the last panel, and I don't want them to have to hang around.

Senator BOSCHWITZ. Why don't we go another 20 minutes with this panel——

The CHAIRMAN. The joint session is at 11——

Senator BOSCHWITZ [continuing]. And then just go on with the next panel?

The CHAIRMAN. Let's continue on with this, but we will have the last panel at 7 in the morning.

Senator BOSCHWITZ. Fine, Mr. Chairman. It is your show, as they say. But there are only three people on that panel. I think we will be done with this group at 11 or a few minutes after, certainly.

The CHAIRMAN. I do not want to cut off any Senator. We had hoped to finish by 10, and we have added an extra hour. I am doing

this so that no Senator will be cut off. I am trying to make sure that every Senator has plenty of time to ask questions. If we were to cut this hearing off at 11, obviously there would not be time to ask questions. I am trying to accommodate Senators as long as they wish to ask questions.

Senator BOSCHWITZ. Well, why don't we go on with panel 5 at 11 or 11:15?

The CHAIRMAN. We cannot, unfortunately.

Senator BOSCHWITZ. Or this afternoon, Mr. Chairman.

The CHAIRMAN. Well, I hate to give them an indefinite time.

Senator BOSCHWITZ. Well, let's give them a definite time. I will do, of course, what the chairman wishes.

Let me ask—I don't quite understand—

The CHAIRMAN. This afternoon, as you know, we have the impeachment trial, which will take all Senators. No committees are allowed to meet this afternoon because of the trial.

Senator BOSCHWITZ. When does the impeachment trial start?

The CHAIRMAN. The impeachment trial begins at 2.

Senator BOSCHWITZ. We can get these folks out.

The CHAIRMAN. And those of us who are involved with that impeachment are meeting for several hours beforehand.

Senator BOSCHWITZ. Oh.

The CHAIRMAN. That involves, incidentally, several members of this committee.

Senator BOSCHWITZ. I see.

The CHAIRMAN. Senators Pryor, Kerrey, Gorton, and Bond.

Go ahead.

Senator BOSCHWITZ. I will be as brief as I can be.

I don't understand the remedies of—and I always relate this to my farmer back in Minnesota. He places an order with Cargill or with an ADM—and it is interesting to note that this whole investigation that we see that has so shaken the industry really began from within the industry itself—but what is that farmer supposed to do if the person with whom he places—with your firm, Mr. Lind, or with another firm, Bob, that you oversee—if he places his order and that company goes and finds a floor trader, and you say that the company that finds the floor trader should have no liability for that floor trader—how do you protect the guy who is placing the order? He has to rely upon somebody, and he places his reliance upon Mr. Lind or upon—I don't want Mr. Lind to answer that question because he doesn't want to be liable—but what remedy does the farmer have back in Granite Falls?

Mr. LIND. Oh, he has a remedy, Senator.

Senator BOSCHWITZ. What is his remedy? How can he possibly exercise that remedy?

Mr. LIND. Well, many times he doesn't even have to exercise the remedy. The rule of the exchange is that if a trader commits an illegal act, that the customer can come after him. I mean, the procedure and the remedy are in place for the customer today at the exchange level to take care of this situation. And in practice, that has happened; since the new audit trail was instituted in the last 3 years, investigations are up, and suspensions and fines are substantially higher, and awards have been made back to the customers in that regard, and I think those awards have been made back—I'm

not certain—but I believe that the awards that the exchanges have given the customers are far greater than what the FBI is totally investigating in its 2 years of undercover work. And this doesn't even have to come from the customer. If in its investigation the exchange finds that there was a trader in the pit who did something illegally, they will make the award back to the customer.

Senator BOSCHWITZ. Do you think, Mr. Lind—

Mr. DAMGARD. Could I touch on that just a moment, Senator? There are really three available remedies. There is the reparations proceeding, there is the arbitration proceeding as well as the courts.

Senator BOSCHWITZ. Are they realistic remedies for some small—

Mr. DAMGARD. Of course, they are. The FCM's go to bat for a customer when he believes has been wronged by a floor trader, and they will force the exchange to discipline that floor trader. And if we are talking about customer restitution here, there may be some other way to go at this besides holding the FCM responsible for treble damages.

I mean, if the court finds that there is an agent relationship, that is one thing. In the real world, Mr. Lind is going to go down there and get the money back from the floor trader so that he won't lose his customer. But the issue here is with an enhanced audit trail, it is the exchange that is going to discover and is charged with discovering the wrongdoing of that floor trader.

Some conversation was had yesterday about including customer restitution as part of the reparations process. Maybe it should also be included as part of the exchange disciplinary process as well. It is unfair for an FCM to be held punitively liable when indeed they haven't done anything and to be charged with the—of course, they do due diligence in selecting the broker, but that's not a very well-defined term. If you end up with a closetful of tickets at the end of 2 years, and you find out later that a floor trader who was licensed and approved by the CFTC and the Board of Trade turned out to be a bad guy, you the FCM, could be liable to the customer for treble damages, and that is just bad legislation, in my judgment.

Mr. WILMOUTH. One of the side effects that could result it seems to me if this were carried through all the way to its conclusion and floor brokers were held liable—I guess the term is "vicariously liable"—for the actions of independent floor brokers, I think you would see people—and he may speak for himself—I think you would see people like Mr. Lind go out of this business. Why would you want to be in this business if you had to have all of that liability?

There is relief now available in civil actions; there is relief available through arbitration procedures.

Senator BOSCHWITZ. Well, we have seen that with doctors as well. No reasonable ability to monitor, as Mr. Lind said in his testimony, and yesterday I got the impression in answer to one of my questions that there was reasonable.

I will look into that further and not delay any further here.

One other question and then a final question. I defined it as 2 cents a trade yesterday, the business of raising \$5 million additional to finance the CFTC in its additional requirements to beef up its

staff as required by this bill. Do you think that that is a harsh penalty or tax or whatever the word should be to impose upon the industry?

Mr. WILMOUTH. To a certain extent I think I do, Senator. I think we must point out that about 25 percent of the trading volume nowadays is done by nonmembers of the exchange, that is, by the general public and by institutions that do not belong to the exchange. NFA charges them a fee for every round turn in order to pay for our services.

Senator BOSCHWITZ. You do not charge a fee to the trader who is trading in his own behalf?

Mr. WILMOUTH. No, we do not charge the floor broker for his own account at all. But I think those people also bear some additional expenses if the exchanges, the CME and the Chicago Board of Trade, have committed \$5 million, that is going to come out of the pockets of the people on the floor, basically. So they would bear a burden.

Senator BOSCHWITZ. You might, if you would, Bob, get me something about that additional \$5 million and why it would be particularly onerous.

Mr. WILMOUTH. I would be happy to supply you information, Senator, on that.

Senator BOSCHWITZ. Yes, if you would, because it is not onerous in my mind now.

One of the other questions, and the final question, I would say to the chairman, that I asked yesterday would be as to the flight of these markets, whether it be to Tokyo, Osaka, or London, and what you think the impact of this legislation, if it goes forward in its present form, would have and whether it would lead to some flight or replacement of these markets in other places.

Mr. WILMOUTH. I think that if any legislation ends up being onerous and exceptionally burdensome on this industry, you are going to find other markets open up someplace else because they don't have the strenuous regulation that we have.

I am a member of an international regulatory group that meets at least twice a year from all over the world, and I am absolutely convinced that if we have overly burdensome regulation, these markets will fly elsewhere because people will tend to go where they don't have as much regulation and where it is easy to do business.

But I also think at the same time that it is necessary for us to have adequate protection for the public. And I think that if we can take this bill and continue to work with staff as we have in the beginning, particularly in the audit trail and dual trading areas and several others, the FCM liability and so on, then I think we can come up with a satisfactory solution which protects the public interest, satisfies, I think, the wishes of Congress and at the same time allows us to have a viable industry which will keep the business here in the United States.

Mr. DAMGARD. I would concur with Mr. Wilmouth, but I would say I count among the members of my organization some of the Japanese exchanges and virtually all of the large Japanese brokerage firms. My international membership list is about 100 firms.

I would say that the big firms, the Shearsons, the Dean Witters, the Merrills, they are all over the world, and they have an obligation to their customer to do the business in the most efficient fashion. If that happens to be on an exchange outside the United States, they have an obligation to the customer to do business there. Frankly, lots of their customers are already outside the United States.

Much of that business is coming to the United States now because we have the best markets, and we have the most liquid markets. Some of these provisions would tie the hands of the exchanges, and naturally they are very concerned. The Board of Trade is bricks and mortar right in Chicago, and they can't go to Japan. Merrill Lynch has a very big office in Tokyo right now and does business in Tokyo with Japanese clients. They expect to do more business in Japan, and of course they are located in other European capitals as well.

But the FCM's are going to be very, very leery of the punitive language in this bill and the extra liabilities that they have under this bill. They probably would indeed seek to do business where they wouldn't be at such high risk.

Mr. ISAACSON. I would like to add one thing. I agree with what they said, however of the \$6 to \$8 billion trading advisors manage, a portion of that is overseas now. We will trade markets overseas where we have advantages, with less regulation than we do here.

Senator BOSCHWITZ. I thank the chairman for his indulgence. I would ask we move forward with the last panel at this time.

The CHAIRMAN. You gentlemen have talked about the costs. One item I should note is that in 1982, the futures industry strongly opposed a user fee of 12 cents per round turn trade on the basis that it would cripple the then-new National Futures Association. The fee was defeated. The NFA then imposed its own fee of 28 cents per public customer trade—a total of about \$25 million per year.

Now, futures trading didn't seem to suffer from that. In fact, volume has doubled. As a result, the NFA fees were reduced to 20 cents per trade. I only mention that to those who are concerned that the service fees under S. 1729 would cripple U.S. competitiveness. In fact, there have been much, much larger fees under NFA, and they have had quite the opposite effect.

I only mention that for whatever it is worth in case the thought was crossing people's minds. I'll be happy to hear any response.

Mr. WILMOUTH. I would be delighted to respond if I can.

The CHAIRMAN. Insofar as it is too late now even to get over to the joint meeting, we will go a few minutes and at least start on the next panel. Then we'll see how we do with our time. I understand now that there is a Senator's breakfast tomorrow morning, and I have also been reminded that I have an 8 a.m. breakfast. If we are unable to finish the panel, then, we will come back at 6 in the morning to make it work.

Mr. WILMOUTH. One minute, if I may. We started out—

The CHAIRMAN. Take all the time you want, Mr. Wilmouth. Time is the one thing we have around here.

Mr. WILMOUTH. We started out at 33 cents a round turn and have reduced the assessment subsequently to 28, 24 and 20 cents a round turn. We have taken over a tremendous amount of responsi-

bilities from the Commodity Futures Trading Commission, expenses which would have otherwise been borne by the U.S. Government. All we are saying is that we think that the trading public already bears a significant portion of the cost of the regulatory burdens that are imposed upon us. But all we are saying is that there are enormous benefits for the general public from this industry, and they should bear some of the costs.

That is not to say that maybe there are certain aspects such as you have clarified in this bill as of yesterday that should be borne somewhere along the line by certain segments of the industry.

The CHAIRMAN. Incidentally, the CFTC is opposed to giving the NFA the right to appeal certain of its decisions to the courts. The CFTC does not have the right to intervene in NFA rulemakings, as it does with the exchanges.

Mr. WILMOUTH. Say that again, Senator.

The CHAIRMAN. Well, the CFTC opposes giving the National Futures Association the right to appeal certain of its decisions to the courts because, unlike with exchanges, the CFTC currently has no right to intervene in NFA rulemakings. That is what the CFTC argues. They cannot alter or supplement—

Mr. WILMOUTH. That's true, but—

The CHAIRMAN. How do you respond? Do you think that you should have the right to appeal their decisions?

Mr. WILMOUTH. Senator, all we're asking for is the right that when they reduce a sanction that we have imposed on somebody who has done something wrong in the futures industry that we have the right to go back and appeal that decision. That is all we are asking. We want to be put on that basis and that basis alone, on an equal footing with the exchanges.

The CHAIRMAN. I thought I might give you a chance to put that on the record.

Mr. WILMOUTH. Thank you very much.

The CHAIRMAN. They probably won't notice your response, but I wanted you to get it on the record.

Senator BOSCHWITZ, do you have any other questions?

Senator BOSCHWITZ. No, I think I covered most of the things that I wanted to cover, Mr. Chairman, but perhaps they can stay around in the event—

The CHAIRMAN. We'll certainly keep the record open for the rest of the day in case anybody wants to submit questions.

Senator BOSCHWITZ. We may submit some questions in writing.

The CHAIRMAN. Thank you, gentlemen, very much.

Why don't we just start for a few minutes with the next panel and see how far we can go.

We have Kendell Keith, who is the executive vice president of the National Grain and Feed Association, submitting to the record the prepared statement of Don McElmury, vice president of CPC International, Inc., who was to testify on behalf of the National Grain and Feed Association;³ Robert Petersen who is president of the National Grain Trade Council, Washington, DC; and Neal Gillen, vice president and general counsel of American Cotton

³ See pp. 646 to 650 for the prepared statement of Don McElmury.

Shippers Association—no stranger to this committee room or this committee.

Mr. Petersen, feel free to take as long as you like.

STATEMENT OF ROBERT PETERSEN, PRESIDENT, NATIONAL GRAIN TRADE COUNCIL, WASHINGTON, DC

Mr. PETERSEN. Thank you, Mr. Chairman.

I am Bob Petersen, president of the National Grain Trade Council. I am substituting this morning for DeVan Janssen, a member of the Council's board of directors, who unfortunately had to leave last night, and he sends his regrets.

While Mr. Janssen would have spoken to you as a market user in his capacity as vice president of Consolidated Grain and Barge Company—

The CHAIRMAN. Incidentally, please explain to Mr. Janssen, if I might interrupt, what I said earlier this morning, that if anybody, after listening to the testimony of others, wishes to add anything, or, if Mr. Janssen would like to respond to any of the statements made earlier, he should feel free to do so.

Mr. PETERSEN. I think Mr. Janssen had considerable sympathy with the issues the committee was grappling with yesterday and sends his regrets.

I will present the Council's views to you this morning.

THE NATIONAL GRAIN TRADE COUNCIL SUPPORTS THE GOALS OF THE LEGISLATION BEFORE THE COMMITTEE TODAY

The National Grain Trade Council supports the goals of the legislation before the committee today. At the same time, however, we do believe U.S. futures markets are fundamentally sound.

WE REMAIN CONFIDENT IN THE EFFECTIVENESS OF EXCHANGE SELF-REGULATION

The Council's members who are commercial market users rely on these markets day in and day out. We remain confident in the effectiveness of exchange self-regulation.

WE AGREE WITH MANY ASPECTS OF S. 1729 BUT HAVE CONCERN OF SOME PROVISIONS

And while we agree with many aspects of the bill before the committee, S.1729, we are concerned by the specifics of some provisions and the vagueness of others.

AUDIT TRAIL PROVISIONS

The Council supports, Mr. Chairman, a workable audit trail system that is efficient, effective and fair. We do, however, have some concerns about the audit trail provisions of the bill.

We believe the best approach to addressing necessary audit trail improvements would be to prescribe the goals, but also give the Commission the latitude to work with exchanges on the most effective means to achieve those goals at each exchange. We suggest the audit trail provisions be revised to recognize that each exchange faces unique conditions, and what may work well at one exchange may not be appropriate at another.

For smaller exchanges, as you have heard, the need to develop tailored technology to meet the requirements could prove to be financially overwhelming. The bill would also mandate that these new audit trail systems be in place within 3 years. The required technology does not now exist to meet these goals.

We hope the technology will come onstream in time to meet those goals, but we think it is potentially disruptive to have a firm requirement that implementation has to take place 3 years hence with technology that does not exist today.

The CHAIRMAN. Do you disagree with the GAO on that?

Mr. PETERSEN. That they should be independent, precise and accurate?

The CHAIRMAN. No, no. On the 3 years. We based the 3 years on their testimony at an earlier hearing.

Mr. PETERSEN. We would hope, as the panel of the major exchanges said yesterday, that they can make it within 1 year or less than 3 years. We are concerned that by carving it in stone and not leaving any leeway in case that eventuality should happen, in case they do put forth their very best efforts but it is just simply not in the cards, we think it would be a good idea to leave some window of flexibility to accommodate that.

The CHAIRMAN. We open those windows every year around here, as you know. But I also find that when we don't put in a time period, we have a sort of Parkinsonian law that many feel is part of the Constitution of the United States. It seems to be ingrained around here.

Mr. PETERSEN. Well, I think, Mr. Chairman, the exchanges certainly have received your message, and I think the bill could be changed in very minor ways to still make it very clear that you expect it to be done within 3 years, but leaving some way in the event of unforeseen circumstances that there would be a safety valve of sorts.

The CHAIRMAN. Thank you. Go ahead.

Mr. PETERSEN. To move on to another favorite subject on service fees—

The CHAIRMAN. I thought you might want to talk about that.

Mr. PETERSEN. Yes. A lot of these are near and dear to our hearts as users, I am afraid.

The CHAIRMAN. What you are saying is that the draft focused your attention.

Mr. PETERSEN. That's exactly right.

SERVICE FEES

We do not quarrel with increasing the Commission's budget, but we do disagree with placing that cost on market users. Mr. Wilmouth pointed out the NFA is funded by the industry at about \$25 million. Users already pay most of the costs of the Commission's designation of new contracts, and users already pay most of the costs for Commission rule enforcement and trade practices review.

We are mindful that other parts of this bill will require exchanges to spend very substantial sums to upgrade and improve their audit and surveillance systems. Therefore it seems inconsistent to us to require exchanges not only to raise new funds for their

own improvements, but also to have the CFTC competing for those funds.

Whether passed on to market users individually by increased charges or directly through a transaction fee, additional CFTC fees would also make U.S. markets less competitive against expanding new foreign markets.

DUAL TRADING

This next one is near and dear to our hearts, too, on dual trading. The Council would oppose an across-the-board ban on dual trading. We recognize that the Senate bill doesn't do that, but we are concerned that the Senate bill could potentially halt dual trading within a year if the Commission isn't satisfied with the exchanges' progress in detecting trading abuses.

We look at the 3-year timeframe on the other audit trail improvements and then look at this very short 1-year window that exchanges would have to prove up on the audit trail, and that concerns us.

Let me just close by saying we stand ready to work with the committee in developing a bill.

Thank you.

The CHAIRMAN. Thank you. I also thank you for your indulgence in coming back here today. I know that you, like Mr. Gillen, were here all day yesterday. I would emphasize again that, having heard that testimony and the answers yesterday, if you find further areas where you wish to respond to or react, feel free to do just that.

I will want to come back to you on the dual trading issue, but I yield to Mr. Gillen, a habit I got into years ago during our law school days. Go ahead.

[The prepared statement of Mr. Janssen follows:]

Statement of

DeVan C. Janssen
Vice President
Consolidated Grain and Barge Company

Representing the
National Grain Trade Council

before the
Committee on Agriculture, Nutrition and Forestry
United States Senate

on

Futures Trading Practices Act of 1989

October 17, 1989

Mr. Chairman and Members of the Committee:

It is a pleasure to have the opportunity to appear before you today to share the National Grain Trade Council's views on S. 1729, a bill to reauthorize the Commodity Futures Trading Commission. I am DeVan C. Janssen, vice president of Consolidated Grain and Barge Company which is headquartered in St. Louis, Missouri. I am a member of the Council's Board of Directors.

The Council is a national trade association whose regular members include grain exchanges, boards of trade, and national grain marketing organizations. The Council has a number of associate members representing a large cross-section of the grain marketing industry.

Council members cover the full spectrum of the agribusiness infrastructure. Our members include firms who handle bulk grains, transportation firms, companies that process agricultural products into consumer-ready items we purchase on the grocery store shelf, cash markets where grain is bought and sold, and futures markets where the price risks associated with merchandising grain are hedged.

Futures markets and the grain trade grew up side-by-side in the United States economy. Since the middle of the last century, the grain industry has relied on futures markets to hedge market risks; and futures markets have fulfilled that purpose in an open and efficient manner. American consumers are thus deep into their second century of enjoying the wide-ranging benefits of price efficiency created by this economic relationship.

The Council supports the goals of the legislation before the Committee today. The bill prescribes a number of tough remedies to guard against abusive trading practices. Obviously, many of these proposed changes are a result of concerns over improper trading activities alleged in on-going judicial proceedings. All market participants have a self-interest in ensuring the most fair and efficient marketplace possible.

The Council does not, however, believe the current futures marketing system is fundamentally flawed. The Council's members who are commercial market users rely on the marketplace as an integral part of their business activity in hedging the price risks associated with cash market activities. We remain confident in the effectiveness of exchange self-regulation. As you know, exchange's have been taking a number of steps to improve their audit trail and surveillance systems. And while we agree with many aspects of the legislation, we are concerned by the lack of detail that accompanies some provisions, and find we must respectfully oppose some other steps which we feel would unduly jeopardize the efficiency of the market.

Market efficiency can be threatened in many ways. Certainly unlawful trading practices undermine market efficiency, but so do impractical and overly restrictive rules. As in so many avenues of life, there is a balance between the

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two questions and we would suggest that some aspects of the bill err on the side of being unworkable and jeopardize market efficiency. We need to remember that fundamentally this nation has an excellent system of markets and has more customer protections than any other market in the world. Changes should fine-tune and improve the market, not render it unworkable or inefficient.

Audit Trail Requirements

The legislation would require that each futures exchange maintain an audit trail capable of capturing transaction times independently, precisely, and completely. The bill would require exchanges to accurately record not only the times of trades in one-minute increments, but also the sequence of trades for each floor trader and broker. Within two years the Commodity Futures Trading Commission, with comments from the General Accounting Office, is required to report to Congress on the progress of exchanges in installing the new systems, including their advice on whether the timetable or statutory standards need adjustment; and within three years exchanges are required to have in place an audit trail system that independently and accurately records the time and sequence of every trade.

The time of execution for all trades must be recorded. In addition, the bill places three more requirements on customer orders to the extent the CFTC determines that is feasible. The legislation directs that, within three years, systems must also record: the time the order is received on the floor, the time the order is received by the broker, and when the order is reported from the exchange floor.

The National Grain Trade Council supports the intent of establishing a workable audit trail system that is efficient, effective, and fair. We do, however, have very real concerns that the new standards, as drafted, do not meet these goals. We believe the best approach to addressing necessary audit trail improvements would be to prescribe more general goals, giving the Commission the latitude to work with exchanges on the most effective means to achieve those goals in light of the particular problems faced by each exchange.

The audit trail provisions implicitly require the development of hand-held computer trade recording devices and electronic order delivery systems. We recommend the audit trail standards be revised to recognize that each exchange faces unique conditions and what may work well at one exchange, may not be appropriate at another. For smaller exchanges, the need to develop tailored technology to meet their needs could prove financially overwhelming to those markets and their member firms. These exchanges generally have lower trading

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volumes, already require one-minute recording of trades, and provide a high level of audit trail accuracy.

The bill would mandate that these new systems be in place within three years. The technology does not now exist to meet these goals, although the two largest exchanges -- the Chicago Board of Trade and the Chicago Mercantile Exchange -- have already committed \$5 million to develop this technology. Whether this technology can be developed and the subsequent systems put in place within three years is an open question. We hope this goal can be met. But, we think it is risky to require the implementation of as-yet undeveloped technology by a date certain.

CFTC Budget/Service Fees

The bill authorizes a 60 percent budget increase for the CFTC over five years. To help finance this funding increase, the legislation expands the Commission's authority to charge service fees. The fees are to reflect the cost to the Commission of (a) monitoring floor trading, (b) supervising exchanges, futures associations, leverage transaction merchants, and others to ensure they are in compliance with the law, (c) analyzing and designating new contracts, and (d) other services as appropriate.

Funding for the Commission would jump by \$25 million under the bill. The Council is not in a position to judge the extent of the Commission's budget needs, although we would agree the Agency's funding in the past has been at minimal levels.

We are very concerned, however, that the cost of the increase would be placed on the users. We would point out that users already fund the entire cost of the National Futures Association whose annual budget is \$25 million, users already pay the Commission's cost of rule enforcement and trade practice reviews, and users already pay for the Commission's cost of designating new contracts. Finally, as logical as it may seem to assess exchanges for increased Commission costs, we should remember this bill will likely require exchanges to spend very substantial sums to upgrade and improve their audit and surveillance systems. Therefore, it seems inconsistent to require exchanges not only to pay for their own improvements, but also those at the CFTC. We suggest it would be better for Congress to ensure that exchange funds are spent on exchange resources since they are at the frontline of the regulatory system.

The magnitude of the budget increase suggests to us that service fees will likely prove to be transaction fees or we would call them transaction taxes. Such a

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tax would increase the cost of doing business on U.S. exchanges, rendering this nation less competitive in a world of dramatically increasing competition.

Conflict of Interest

The bill contains two provisions designed to prevent conflict of interest in exchange emergencies: (1) exchange directors must abstain from any matter where they, or a close associate, are a direct, specific party in interest; and (2) before any emergency deliberation, board or committee members must disclose positions in the market, including positions held to their knowledge in accounts at affiliated firms.

The Council is concerned with both provisions of this proposal. The first element of the proposal is but one example of where more harm may be done than good. If new section 17(B) would merely prohibit an exchange director from voting on any issue if the director or a close associate were a named party in the matter being voted on, then of course, we would agree. If, however, it would mean that director would have to recuse himself if he or his employer, for example, had a position in the same commodity as someone else subject to board action, that would be detrimental to effective self-regulation. At its extreme, this could well preclude anyone who is active in a meaningful way in the market from participating in board decisions. This would likely include both employees of commercial firms and futures commission merchants where the firms or their customers participate in virtually every market traded.

We are further concerned about requiring disclosure of positions in a semi-public setting. Commodity marketing and futures trading are intensely competitive businesses; businesses where if a competitor is aware of your strategy or market position, the individual would be placed at a disadvantage. We are deeply concerned that exchange members, confronted with even a remote possibility they may have to disclose their market position, would decline to serve on exchange boards or committees.

As an alternative to requiring disclosure to exchange boards or committees, we would suggest in this situation that individuals be given the opportunity to make such a disclosure to exchange surveillance or legal staff. And that this staff, with the aid of general guidelines from the Commission, make a recommendation to the individual on whether recusal is necessary or appropriate. Given that exchange emergency actions are automatically subject to review by the Commission, and often subject to public scrutiny, we believe such an alternative would achieve the desired goal.

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We do not think it is desirable to create a situation where the most qualified and knowledgeable exchange members are discouraged from participating in exchange self-governance. Successful self-regulation is based on self-interest, and that a balance of these interests will provide the best and most fair decisions for all parties. As we said before, the Council believes in self-regulation and that it has proven its value.

Civil Liability of Brokerage Firms

The bill would hold futures commission merchants jointly liable with a floor trader for losses caused by malfeasance of the floor broker. The bill goes one step further to specify that if an FCM fails to exercise due diligence in selecting floor brokers or monitoring trades, then the FCM would be liable for punitive damages as well.

We are very troubled by this broad expansion of liability and the vague nature of the term "due diligence." Could this mean a broker taking a brief, personal break from the trading floor has not exercised due diligence? And would an FCM then be liable as well? The addition of punitive damages to the FCM's liability means a firm could face virtually unlimited damage awards. One result of this provision is likely to be the disappearance of independent floor brokers. That, in turn, would seriously hamper the ability of commercial users to put on and take off large hedge positions -- which typically requires the use of independent brokers who cannot be identified with their particular customers.

Deficiency Orders

The bill would require the CFTC to issue "deficiency orders" when the agency finds flaws in exchange trade surveillance systems or their effectiveness in detecting violations. We have a number of concerns about this approach which would codify how and what the CFTC should say to exchanges -- across the board -- for any deficiencies the Commission might find.

The Council believes the approach to deficiency orders needs to be reconsidered for several reasons. First, the law cannot anticipate contingencies and the need for flexible responses they may require. Moreover, a statutory scheme freezes the Commission's ability to craft particular approaches to different problems at different exchanges. Finally, codifying today's specific expectations of regulatory behavior will prohibit the Commission from using its expertise to develop better responses to given problems.

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Serious problems would exist with respect to exchanges' abilities to contest or challenge such orders. While the bill would require the CFTC to give exchanges the right to petition the Commission for reconsideration or delay, such relief would require the Commission to find, against itself, that its own order was arbitrary and capricious, or constituted an abuse of its own discretion. Furthermore, judicial review of such Commission determinations would be restricted to the very narrow standards applicable to review of agency emergency actions, rather than the traditional authority federal courts of appeals hold to review administrative agency orders.

Dual Trading

The bill, during the first year after enactment, would require the Commission to suspend dual trading at each exchange under a deficiency order unless the exchange demonstrates that its trade oversight system, including the audit trail, can and does detect dual trading-related abuses.

The Council would oppose an across-the-board ban on dual trading. We believe dual trading contributes importantly as an adjunct source of market liquidity, particularly in the back months of futures contracts, allowing commercial users to hedge future sales.

We do not, however, oppose the provisions of S. 1729 with regard to dual trading. We believe the provision appropriately predicates the continuation of dual trading on the existence of accurate audit trails and effective surveillance programs. We believe the provision is constructive in allowing the Commission the flexibility to fashion a suspension of dual trading to the particular circumstances of the affected exchange.

The National Grain Trade Council supports a number of the features of S. 1729, including provisions to:

- o require the registration of floor brokers,
- o require courses in ethics, and
- o expand the public membership on exchange boards.

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Conclusion

While the Council's statement has focused on our concerns with aspects of S. 1729, we support many features of the bill. And we certainly support the overall intent and objectives of the legislation.

As the Committee deliberates on this legislation, we urge you to keep an eye toward what greater contributions American futures markets can provide our country. The National Grain Trade Council stands ready to assist the Committee in developing a workable system that is efficient, effective, and fair.

STATEMENT OF NEAL P. GILLEN, VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN COTTON SHIPPERS ASSOCIATION, WASHINGTON, DC

Mr. GILLEN. Thank you, Mr. Chairman.

I think it is appropriate to note at the outset that in 1974 Mr. Petersen's organization and my organization were only two of the three organizations who supported the enactment of an independent regulatory agency to regulate futures markets. The other was the NFO, and they were here this morning.

I am Neal P. Gillen. I am vice president and general counsel of the American Cotton Shippers Association (ACSA).

THE ASSOCIATION ENDORSES THE REAUTHORIZATION OF THE CFTC

The Association endorses the reauthorization of the CFTC and urges the committee not to penalize commercial users of the New York Cotton Exchange No. 2 cotton contract by placing unnecessary restrictions on industry practices or on the trading of cotton futures or option contracts. The cotton industry has confidence in the contract and the market where it is traded.

INTEREST OF ASCA

ACSA's 525 member firms are the customers of the futures markets and for whom the laws and regulations are designed to protect. To function effectively in the marketplace farmers, merchants, cooperatives, and textile mills must have a viable cotton futures market.

AN EXAMPLE OF A RECENT EXPERIENCE

Let me just cite an example of a recent experience where I was attending a series of international meetings in Liverpool, England. The first afternoon I was there, at approximately 3, suddenly someone called for a recess, and people from Russia, Poland, Spain, Brazil, from cotton producing countries all over the world left the room. Why? Because at that time, the New York cotton futures market was opening, and it is a contract upon which each and every country that produces cotton depends upon because it is a market in which they have total confidence.

ACSA is proud that in 1974 it was one of the few agricultural or trade organizations that supported the establishment of a independent regulatory agency to oversee U.S. futures markets. Since then, ACSA has worked closely with the Commission on numerous matters to assure that the cotton industry from field to mill has a properly functioning price discovery mechanism replete with the necessary requisite safeguards.

In our opinion, the Commission has properly exercised its substantial authority with minimum interference of the New York Cotton Exchange No. 2 Contract. Further, the Commission through its Agricultural Advisory Committee, chaired by the capable Commissioner Kalo Hineman, undertakes a substantial and continuing effort to listen to and inform the agriculture community on all issues within the Commission's jurisdiction. No other regulatory agency which impacts on U.S. agriculture undertakes such an effort.

DUAL TRADING

Apart from the obvious necessity of contract liquidity to make a futures market economically viable, the key to the effective operation of a futures contract is the efficient execution of trades by floor brokers. Poor executions penalize the customer as he or she will pay more or receive less in a given trade. Every commercial hedger seeks to utilize the best traders given the importance of good trade executions.

A law or regulation which restricts the floor trader by giving him or her a choice to trade for their own account or the account of others will result in the skilled trader choosing to trade for his or her self. The commercial users of the contract will suffer as their trades will be handled by the lesser skilled floor traders resulting in poor trade executions and monetary losses.

INSIDER TRADING

I would like to address the issue of insider trading which is not contained in your bill, Mr. Chairman, but this causes some problems as it was adopted by the House.

It has been sound public policy to recognize the distinction between securities and commodities. For sensible reasons there exists a different standard for stock or option trades by the officers or employees of publicly traded corporations and the futures trading of the principals, partners or employees of agricultural merchant firms, the officers or employees of agricultural cooperatives or the officers, partners, or employees of mills or processors of agricultural commodities.

If we all acknowledge the fundamental differences in the instruments we should maintain the differences in the obligations of the parties involved in these uniquely different industries.

In publicly traded securities the insiders, the officers, employees, accountants, lawyers, underwriters, and investment bankers have a direct and legally defined duty and responsibility to the shareholders and the members of the public not to divulge certain knowledge or utilize it to their financial benefit. The insider is obligated to make public material information or events which will influence the value of the stock.

By contrast, it is not necessary to impose such a duty or responsibility in the commodity or cash markets. Here, all market participants have access to a multitude of factors which influence the supply, demand and price of a commodity. Further, as all market participants have varying access to different types of market information there is no centralized responsibility, as there is within a publicly traded corporation, to share or exclude information from market participants regarding events or impending events which may or may not influence commodity prices. In cotton a mill might anticipate record sales or slowdowns based on orders for finished goods or yarn, yet another mill may have the opposite experience. The same is true for cotton merchants or cooperatives. Their respective experience may influence them to take opposite positions in the market. The so-called inside market information may not help them, as unlike the corporate insider who stands to gain from

his information, facts discovered by the commodity futures trader could result in market losses.

[The prepared statement of Mr. Gillen follows:]

Statement
of Neal P. Gillen
Vice President & General Counsel
of the
American Cotton Shippers Association
on Reauthorization of the
Commodity Futures Trading Commission
Presented to
Committee on Agriculture, Nutrition & Forestry
U.S. Senate
October 17, 1989

The American Cotton Shippers Association endorses the reauthorization of the Commodity Futures Trading Commission and urges the Committee not to penalize commercial users of the New York Cotton Exchange No. 2 cotton contract by placing unnecessary restrictions on industry practices or on the trading of cotton futures or option contracts.

Interest of ACSA

ACSA was founded in 1924 and is composed of merchants, shippers and exporters of raw cotton who are members of five federated associations, located in sixteen states throughout the cotton belt:

Arkansas-Missouri Cotton Trade Association
Atlantic Cotton Association
Southern Cotton Association
Texas Cotton Association
Western Cotton Shippers Association

ACSA's 525 member firms handle over 80% of the domestic cotton crop and 90% of the export market. In 1989-90, 8 million bales of U.S. cotton will be consumed by domestic mills and 7.8 million will be shipped to foreign mills. To function effectively in the marketplace farmers, merchants, cooperatives, and textile mills must have a viable futures contract.

ACSA is proud that in 1974 it was one of the few agricultural or trade organizations that supported the establishment of an independent regulatory agency to oversee U.S. futures markets. Since then, ACSA has worked closely with the Commission on numerous matters to assure that the cotton industry from field to mill has a properly functioning price discovery mechanism replete with the necessary requisite safeguards.

In our opinion the Commission has properly exercised its substantial authority with minimum interference of the New York Cotton Exchange No. 2 Contract. Further, the Commission through its Agricultural Advisory Committee, Chaired by

Commissioner Kalo Hineman, undertakes a substantial and continuing effort to listen to and inform the agriculture community on all issues within the Commission's jurisdiction. No other regulatory agency which impacts on U.S. agriculture undertakes such an effort.

Dual Trading

Apart from the obvious necessity of contract liquidity to make a futures contract economically viable, the key to the effective operation of a futures contract is the efficient execution of trades by floor brokers. Poor executions penalize the customer as he or she will pay more or receive less in a given trade. Floor trading is a demanding occupation and the performance of individual traders differs according to the ability of the trader. Individuals with physical stamina and quick and reflexive minds have superior trading ability, while others lacking these skills are average or poor traders. Every commercial hedger seeks to utilize the best traders given the importance of good trade executions.

A law or regulation which restricts the floor trader by giving him or her a choice to trade for their own account or the account of others will result in the skilled trader choosing to trade for his or herself. The commercial users of the contract will suffer as their trades will be handled by the lesser skilled floor traders resulting in poor trade executions and monetary losses.

ACSA's members and others in the industry are opposed to the adoption of regulations which would restrict the practice of dual trading on the N.Y. Cotton Exchange No. 2 Contract. It is our considered judgment that the CFTC has sufficient authority and knowledge of the subject area to regulate when they deem it necessary.

Insider Trading

While the bill introduced by Senators Leahy and Lugar does not contain an insider trading position, we find the provision adopted by the House sufficiently intrusive on common industry practices to express our concerns and recommendations to the Senate.

It has been sound public policy to recognize the distinction between securities and commodities. For sensible reasons there exists a different standard for stock or option trades by the officers or employees of

publicly traded corporations and the futures trading of the principals, partners or employees of agricultural merchant firms, the officers or employees of agricultural cooperatives or the officers, partners, or employees of mills or processors of agricultural commodities.

If we all acknowledge the fundamental differences in the instruments we should maintain the differences in the obligations of the parties involved in these uniquely different industries.

In publicly traded securities the insiders, the officers, employees, accountants, lawyers, underwriters, and investment bankers have a direct and legally defined duty and responsibility to the shareholders and the members of the public not to divulge certain knowledge or utilize it to their financial benefit. The insider is obligated to make public material information or events which will influence the value of the stock.

By contrast, it is not necessary to impose such a duty or responsibility in the commodity or cash markets. Here, all market participants have access to a multitude of factors which influence the supply, demand and price of a commodity. Further, as all market participants have varying access to different types of market information there is no centralized responsibility, as there is within a publicly traded corporation, to share or exclude information from market participants regarding events or impending events which may or may not influence commodity prices. In cotton a mill might anticipate record sales or slow-downs based on orders for finished goods or yarn, yet another mill may have the opposite experience. The same is true for cotton merchants or cooperatives. Their respective experience may influence them to take opposite positions in the market. The so called inside market information may not help them, as unlike the corporate insider who stands to gain from his information, facts discovered by the commodity futures trader could result in market losses.

Information from farmers, ginner, merchants domestic and foreign mills, retailers, weather analysts, USDA and foreign governments and reports from various news agencies is shared and assimilated in the spot markets and in the cotton exchange where in a quick and efficient manner the price discovery system assigns values to the commodity. Why restrict the sharing of this information, especially when the same facts will often result in different market positions being taken by individuals having equal access to the

same information? Why restrict the market participation of people in an industry because of their particular knowledge of a market and their willingness to speculate on the direction the market might take?

We recommend that the Congress acknowledge the differences between securities and commodity trading and the use of market information by not restricting current industry practices of utilizing such information to expand or contract a spot or futures position and by not prohibiting individuals who work within the industry from futures trading for their own account.

In our opinion it would be appropriate to limit commodity trading by employees of the U.S. Government particularly those in USDA, CFTC, SEC, Federal Reserve, Treasury, State or Commerce who have access to information not available to the industry and the speculating public which could influence commodity markets and the employees or officers of self regulatory organizations or commodity exchanges who have access to similar market sensitive information.

I thank the Committee for the opportunity to present our views and I will endeavor to respond to any questions you might have at this time.

The CHAIRMAN. Mr. Gillen, I might say that in that regard, we looked through all the cases, all the indictments and investigations. Insider trading was not one of the allegations made. That's one reason why the legislation introduced by Senator Lugar and myself does not address that area.

I suspect that it will be a matter of debate in the other body. If it is still in their bill when it gets done, it will be a matter for the conference, of course.

I am more concerned about dual trading, which of course was alleged in the indictments. In that regard, I would go back to some of the testimony we heard yesterday. One thing that came up over and over among the Senators who were asking questions of those testifying pro and con on the Leahy-Lugar bill was the issue of credibility of the markets. Futures markets work only if they are credible, only if you can rely on them.

Our bill allows dual trading based on the realization that there are areas where it is needed to make markets. But if there is anything that is a lightning rod with the public, which often doesn't understand the differences between the various types of markets, it is dual trading. I think we all accept that.

We have a tough provision, as Mr. Petersen said, especially because it has a 1 year timeframe. It is designed specifically for that purpose, to keep a fairly short rein.

Now, putting aside the time limit just for the moment—and I will ask both Mr. Petersen and Mr. Gillen the same question: do you think that the approach taken in our bill, which allows dual trading to continue so long as the exchange can police its floors against dual trading-related abuses, is a workable means of regulating this procedure?

Let me start with Mr. Petersen and then go to Mr. Gillen, leaving aside for just a moment the 1-year limitation.

Mr. PETERSEN. We agree with your approach, Mr. Chairman. We don't have any objection to predicating continuance of dual trading on some type of strict standard.

The CHAIRMAN. Then feel free to address the time limit.

Mr. PETERSEN. OK. I would observe that yesterday—and I forget which witness it was; maybe it was Mr. Fink with COMEX—talked about burden of proof in the dual trading section where now, the way it is written, the burden of proof is on the exchanges to demonstrate that they can do it. I would agree with his point—we feel the burden should be on the Commission to prove there is a problem. But we don't disagree with requiring that good systems be in place.

And on the 1-year timeframe, I would just simply say we don't feel it is consistent with the 3-year, and I think it would be more workable if it were changed to the 3-year.

If I can add just one more comment before I close, if Mr. DeVan Janssen had been here—he is a commercial grain guy—he was telling me that their main broker is a dual trader in the pit in Chicago, and he is their main broker because he does the best job for them and that they would very much hate to lose him. And Van feels that the better brokers tend to be dual traders. He is very concerned that if we should have strict limits that a lot of them

will opt to trade for their own account. That doesn't help market efficiency.

The CHAIRMAN. Mr. Gillen.

Mr. GILLEN. Senator, I tend to agree with the statement made by Mr. Melamed. I would rather let the technology develop itself. Insofar as the cotton contract is concerned, there is no problem. It is a small contract.

The CHAIRMAN. I don't understand your answer. What does technology have to do with the exchanges' policing the floors against dual trading-related abuses?

Mr. GILLEN. Well, I have no problems with that. I thought you were referring to the 3-year timeframe—

The CHAIRMAN. No, no. I'm sorry. I was referring to the question of our approach which allows dual trading to continue so long as the exchange polices its floors against the dual trading-related abuses.

Mr. GILLEN. I have no particular qualms—let me rephrase that—

The CHAIRMAN. In other words, dual trading continues so long as the exchange demonstrates that it can police its floors against abuses.

Mr. GILLEN. Well, in the cotton contract, we have no problems at all. We are convinced that they are doing an adequate job. Insofar as the larger exchanges go, if you are asking me to opine, my experience from my association with the futures industry for some 25 years is that I think the managers of the exchanges are quite concerned about the integrity of the exchanges, and they will make an all-out effort to comply as best they can in whatever time limit you propose.

The CHAIRMAN. Under this bill, they would have to, or dual trading is gone.

How concerned are you about orders you send out being mishandled on the exchange floor? Has that been a problem for you?

Mr. GILLEN. Well, I have a managed futures account personally, and I have never had any concerns. I have never had any suspicions that I was being taken for a ride.

The CHAIRMAN. Mr. Petersen.

Mr. PETERSEN. Our members have always been very confident in the system, and as I said, maybe not clearly enough, they are in the market all the time, and if they don't feel that they are being treated well, they will find somebody who will. So they are intimately familiar with the market and they remain confident in the market.

The CHAIRMAN. Do they feel they have enough choice if they do have concerns they can go elsewhere?

Mr. PETERSEN. No question.

The CHAIRMAN. Thank you.

Senator Boschwitz.

Senator BOSCHWITZ. I am just looking at the GAO report because as I recall, dual trading was not particularly thought to be part of the problem because they thought that while dual trading provides an opportunity to take advantage of the customers, Department of Justice indictments show that any abuse that a dual trader broker can commit alone can also be committed by nondual trading bro-

kers working together. Therefore it is unclear to what extent eliminating dual trading will reduce trade practice abuses. Then they go on to say a better deterrent would be for the exchanges to precisely and independently time the progress of customer orders, and that's the whole business of the trail. This timing data would better enable the exchange to identify and document cases.

So that we will also look at that carefully. Do you agree, Mr. Gillen—it is a shame that we are not bringing Neal Gillen back at 6 in the morning, I might say; he has, as the chairman has noted—

The CHAIRMAN. It builds character.

Senator BOSCHWITZ. It builds character—are you suggesting, Mr. Chairman, that Mr. Gillen needs additional character?

The CHAIRMAN. I was thinking of the members. [Laughter.]

Senator BOSCHWITZ. Touché, Mr. Chairman.

Do you agree, too, that the burden of proof should be on the CFTC rather than the exchanges to establish the not necessity, but desirability of ending dual trading?

Mr. GILLEN. Well, I think it is the responsibility clearly of the exchanges to take the appropriate safeguards to see that there are no abuses committed before, during or after trading hours. Insofar as the Commission is concerned, the Commission has an obligation to prescribe regulations based upon its analysis of the activity in the particular market.

Senator BOSCHWITZ. Just as a matter of question, because I'm not so familiar with the Cotton Exchange; it is a smaller exchange, and therefore some of these smaller exchanges—I know that my Minneapolis exchange spoke very feelingly about the need for dual trading—I presume that applies as well to the Cotton Exchange.

Mr. GILLEN. That's a case in point, yes.

Senator BOSCHWITZ. Let me also ask you about the open outcry, what you, Mr. Petersen and Mr. Gillen, feel about the open outcry, whether or not it can be replaced or whether or not it is still a necessity of the exchanges as you see them.

Mr. GILLEN. Well, I started to answer this question before. I believe in the open outcry system, but one has to acknowledge technological advances.

In listening to the testimony yesterday, Mr. Melamed indicated that without the impetus of this legislation or Commission regulations, they have been attempting to develop technology, and I think the technology should be permitted to develop so the open outcry system can be made more efficient.

It has been my experience that the people in the markets are very supportive of any device that will permit them to increase the number of trades they engage in as this will increase their potential to make or lose money in a given situation.

Mr. PETERSEN. Senator Boschwitz, our members are strongly committed to the open outcry system. We continue to think it is the most effective and efficient way of transacting business in that environment, and we think the human interaction that goes with it makes it so.

I might also point out that with the alternative being computer systems, I'm not sure that those are always infallible, and they may raise just as many or more problems than we may be solving.

Senator BOSCHWITZ. I noted that yesterday, that some people seem to be able to bug or de-bug—I am not entirely of the computer age, and I don't have this love affair with computers, so perhaps I am not as understanding of it as I should be. But I also am concerned that in spite of a total trail, that that may not lead to some new abuses that we have not yet contemplated—though if there is a total trail, and if it is a closer trail, one would think that the possibility and leverage for abuses is more limited.

I would say, Mr. Chairman, that as I indicated to you, I didn't think this panel would take very long, at least as far as I was concerned. It is a shame to let them go so quickly and not return early tomorrow morning, but I have no further questions.

The CHAIRMAN. Do you mean you don't want to come back and meet with me just on general principle around 6 tomorrow morning?

Senator BOSCHWITZ. Well, I might.

The CHAIRMAN. You are probably one of the people who lallygags in here at 7 in the morning.

Senator BOSCHWITZ. I am a better sleeper than the chairman.

The CHAIRMAN. And you will probably live longer for it.

Gentlemen, notwithstanding some of the levity that you may have seen here, I consider this series of hearings extremely important. I have tried to provide all Senators with all the time they wanted because I think that this is a very, very important area. The Senator from Minnesota has asked, both yesterday and today, some extremely important questions which will help the hearing record, as have all Senators. I would note for the record that if Senators need further information on this, we will do everything possible, either formally or informally, to make it available. This committee will have to tackle in this legislation one of its most important challenges of this Congress—this and the farm bill itself. In many ways, its lasting effect will be just as important as that of the farm bill. So I appreciate all the time you have taken.

Thank you. We stand in recess.

[Whereupon, at 11:30 a.m., the committee was adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

APPENDIX

PREPARED STATEMENT OF PHILIP A. FEIGIN, CHAIRMAN OF THE ENFORCEMENT SECTION, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., WASHINGTON, DC

Mr. Chairman and members of the committee:

My name is Philip A. Feigin. I am chairman of the Enforcement Section of the North American Securities Administrators Association (NASAA)¹ and commissioner of the Colorado Division of Securities. I appreciate the opportunity to offer NASAA's views on the proposed "Futures Trading Practices Act of 1989."

Mr. Chairman and Senator Lugar, NASAA commends you for offering a comprehensive legislative package designed to improve regulatory oversight of the commodities markets. If adopted, the Futures Trading Practices Act of 1989 may well pave the way for renewed investor confidence in the operations and fairness of the commodities markets. The proposed legislation will send a clear signal to brokers and traders in the futures pits that fraud and abuse will no longer be tolerated. Criminal activity will be detected and wrongdoers punished.

Much of my more than 10 years in State securities regulation and enforcement has been devoted to fighting commodities fraud. For several years, I served as chair of the NASAA Commodities Committee and have been a member of the Advisory Committee on State/Commodity Futures Trading Commission Cooperation for more than 3 years.

In my 10 years of State investor protection experience, white collar crime has grown from a major problem to a national catastrophe. These financial crimes have become as complex as they are disturbing. Scandals involving widespread commodities fraud, insider trading, manipulation of the penny stock market, savings and loan fraud, money laundering, and defense contractor fraud have significantly eroded the public's faith in our financial markets, industries and financial institutions and have raised fundamental questions about our Nation's commercial ethics. White collar crime has reached crisis proportions. What are investors and the public to think? Is the deck stacked so heavily against them that to participate in our financial markets is to be naively foolhardy?

By and large, individual investors remain skeptical about participating in financial markets they perceive to be dominated by institutions and insiders—and rigged against them. In a June 1989 *BusinessWeek/Harris Poll* public opinion survey about the treatment of individual investors in the financial markets, respondents were asked whether the individual stands a chance against big institutional traders and market professionals. A full 68 percent said that the individual "does not stand a chance," while only 23 percent responded that an "individual investor gets treated fairly."

The exodus of the individual investor from the financial markets commencing with the crash of October 1987, and the attendant rise in market volatility, such as we are currently witnessing, illustrate once again that the confidence of the investing public is crucial to stable and sound financial markets.

THE CURRENT SYSTEM IS NOT WORKING

Federal authorities announced in August the long-awaited indictments of 46 traders on the world's largest commodities exchanges—the Chicago Mercantile Ex-

¹ NASAA is the national voice of the 50 State agencies responsible for the protection of investors and the efficient functioning of the capital markets at the grassroots level in the United States.

change and the Chicago Board of Trade. The charges resulted from a 2-year sting operation that put wired, undercover Federal Bureau of Investigation (FBI) agents in the trading pits. The allegations, if true, document market frauds more inventive than anything Ivan Boesky ever conceived.

The widespread fraud and manipulation uncovered in the Federal investigation into Chicago's commodities markets raised critical questions about the integrity of the futures trading process and its regulation. The conclusion is now inescapable: Weak laws, lax enforcement and oversight, and a Federal regulatory agency hampered by inadequate funding, all combine to create an environment in which market professionals have every incentive and opportunity to cheat investors for their own enrichment. Clearly, the system is not working.

The underfunded and understaffed Commodity Futures Trading Commission (CFTC) simply cannot effectively oversee the burgeoning futures markets. Over its 15 year life, the CFTC has not been known for ferreting out much trading abuse—nor is it well equipped to do so. While NASAA has great respect for the agency's Enforcement Division, we also know that they are hopelessly outgunned. The staff has done remarkably well over the years, given their meager resources and the problems associated with enforcing the Commodity Exchange Act.

While not directly comparable, it is nonetheless instructive to take a side-by-side look at the resources and staff of the Securities and Exchange Commission (SEC) and of the CFTC. The bottom line: The SEC has nearly four times the budget and staff of the CFTC. In addition, the SEC has 50 State securities agencies working along side them to protect the integrity of capital markets. Since Federal commodities law preempts the States from regulating the commodities exchange industry, the CFTC stands alone to police this burgeoning marketplace.

With an annual budget of \$34.7 million and a total staff of 535, the CFTC is expected to oversee a marketplace which has experienced explosive growth in the last decade. One measure of the exchanges' growth is seen in the number of contracts traded. Volume is heaviest at the Chicago Board of Trade, where 143 million contracts changed hands last year, up from 23 million in 1977. During the same period, contracts at the Chicago Mercantile Exchange rose to 78 million, up from 7.9 million.

The CFTC has not kept pace with this growth—neither in terms of resources, nor in terms of more modernized and stringent regulations to stop fraud and trading abuses. NASAA has joined the chorus of voices over the last several years warning that gaps in futures regulation and inadequate resources were making it easy for brokers to cheat customers, while at the same time making it almost impossible to catch those who cheat. This can obviously no longer be tolerated.

Last year, the CFTC brought a mere 48 enforcement actions for commodity-trading rule violations. The SEC, by comparison, brought 252 cases of insider trading and other violations of the securities laws. Critics of the CFTC may look at this number—48 enforcement actions—and assume that the Commission has fallen down on the job. We suggest that there is another explanation for the comparatively low level of enforcement activity emanating from the Commission: The violations involved are incredibly complex and not easily subject to detection, and the CFTC is attempting this task with woefully inadequate resources.

The lack of resources and regulatory authority provided to the Federal agency charged with protecting the integrity of the futures markets has been justified traditionally by the claims that the exchanges can police themselves. While it is now obvious to even the most casual observer that the exchanges have not adequately policed themselves, NASAA respectfully submits that a regulatory system that relies almost exclusively on self-regulation is inherently flawed. And, the deficiencies in the self-regulation system are compounded when a closed community operates with little or no public scrutiny. The fact that the widespread fraud in the futures pits was revealed only after undercover moles penetrated the system is a powerful indictment of the current exchange self-regulatory approach.

Have the exchanges proven themselves up to the task of policing their own members and markets? The March 1989 report of the General Accounting Office (GAO), "Chicago Futures Market: Initial Observations on Trade Practice Abuses," casts a skeptical eye on the exchange self-regulatory system. After reviewing the data contained in the GAO report, one must conclude that the number of disciplinary actions taken against commodities trading professionals in recent years does not necessarily reflect the magnitude of abuse at the Nation's largest futures markets.

The number of trading professionals sanctioned for violations on the floor of the Chicago Mercantile Exchange (CME) rose from 13 in 1984 to 105 in 1988, while sanctions at the Chicago Board of Trade (CBT) went from a low of 8 in 1985 to a high of 32 in 1986. In 1988, the CBT penalized 13 floor participants. CME fines for trade

practice abuses totaled approximately \$3.6 million over the most recent 5-year period. The CBT in this 5-year period handed out a total of approximately \$811,000 in fines. Given the volume of trading on the exchanges and the results of the FBI sting, one must wonder why so few violators were detected through the exchange oversight program. The number of members expelled on both exchanges averaged about two a year.

Why are so few violations detected and punished by the exchanges? It certainly is not because the violations are not occurring. Perhaps detection and punishment of wrongdoers is not a high priority of the exchanges. We believe self-regulation can be an effective component of a comprehensive regulatory scheme, but only when there is a powerful, active and well-funded government regulator involved.

NASAA SUPPORTS THE FUTURES TRADING PRACTICES ACT OF 1989

The "Futures Trading Practices Act of 1989" recognizes the deficiencies in the current regulatory system, and through several improvements, sets in place the mechanisms for restoring integrity to the markets.

Who has been harmed by the pervasive cheating in the futures pits? Individual investors—the customers of big brokerage houses—who are perhaps most vulnerable to abuse. Typically, the individual investor is the farthest removed from the trading floor and is the least able to marshal enough "inside information" on trading-pit activities to defend him or herself. Many individuals participate in the futures markets through commodities funds and pools—managed accounts and funds used by a wide range of individuals and brokers to diversify their investment portfolios. Big commodity funds, which are roughly similar to mutual funds, may be particularly vulnerable to front-running and other abuses, because they frequently use outside brokers to execute trades. Most importantly, our entire financial system is harmed when it is undermined by fraud, abuse and corruption. The futures markets have evolved from the relatively quiet days of trading agricultural commodities to the volatile financial marketplace of the world it is today.

NASAA strongly supports the provisions of the *Futures Trading Practices of 1989* which would:

- Hike the budget of the CFTC;
- Improve CFTC exchange oversight and exchange accountability;
- Provide for *treble* damages to defrauded investors and enhanced private civil liability;
- Provide enhanced CFTC authority to levy fines and penalties; and
- Impose new restrictions on telemarketers.

These proposed reforms, if enacted, will go a long way toward giving both investors and the CFTC an even chance at combating the frauds evidenced by the indictments in Chicago.

CFTC RESOURCES

The proposed legislation authorizes a 60 percent budget increase for the CFTC over a 5-year period. These desperately needed additional resources will allow for a greater CFTC presence on trading floors, strengthened oversight of exchange self-regulatory programs, heightened monitoring of computer technology and more staff to develop and prosecute enforcement actions.

While NASAA recognizes that the expansion of the CFTC's authority to charge service fees may be controversial, we nonetheless believe it is an appropriate and necessary authority. Let those who use the commodities pay for their regulation.

IMPROVED EXCHANGE ACCOUNTABILITY AND CFTC OVERSIGHT

The simple fact is that exchange self-regulation, in its current form, has not worked. There must be strengthened CFTC oversight and improved exchange accountability if the integrity of the marketplace and investor confidence is to be restored.

First, technological advances make possible an enhanced audit trail system capable of capturing transaction times independently, precisely and completely. There is no acceptable reason why state-of-the-art systems should not be put in place immediately.

Second, the CFTC will be empowered to suspend the highly questionable practice of dual trading—the commodities markets equivalent of insider trading in securities—unless an exchange can demonstrate that systems are in place that can and do detect dual trading-related abuses.

Third, the CFTC will be given both greater oversight authority over the exchanges and an enhanced participatory role in the development and implementation of exchange self-regulation.

ENHANCED CIVIL LIABILITY AND PENALTIES

Many of the fraud charges brought against participants at the Chicago Board of Trade and Chicago Mercantile Exchange stemmed from allegations of brokers cheating customers and then covering up their alleged wrongdoing with doctored records. Even in the face of the potential ramifications of liability under the Racketeer Influenced and Corrupt Organizations (RICO) Act, with its treble damages, forfeiture provisions and enhanced criminal exposure, these defendants apparently thought it was worth the risk. Simple damages would merely provide that, when caught, the defrauding party must simply return the ill-gotten gains. This is not the type of remedy that can be expected to effectively deter such insidious fraud.

NASAA strongly supports the provisions in the proposed legislation which will: (1) make futures commission merchants (FCM) liable for customer losses caused by malfeasance of a floor broker it selects to execute the customer's trade; and (2) allows a defrauded investor to seek *treble* damages if an FCM willfully and intentionally fails to exercise due diligence in selecting or monitoring the activities of a floor broker.

ENHANCED PENALTIES

The proposed legislation enhances the CFTC's fining authority and increases the amount of the fines that may be imposed in criminal proceedings. We certainly support these enhancements in the wake of the recent history of indictments. In addition, NASAA supports the proposal which would give the CFTC the authority to seek restitution in its own enforcement actions. Given the Commission's reluctance to support the restitution proposal, we believe that a congressional mandate in this regard is made all the more important.

As to the criminal sanctions, it should be noted that to our knowledge, the criminal provisions of the Commodity Exchange Act (CEA) have only rarely been utilized by Federal prosecutors. Rather, these prosecutors rely on the mail and wire fraud provisions almost exclusively in bringing commodity fraud cases. This is true even though the penal provisions of the CEA provide some greater penalties. One need only briefly examine the CEA criminal provisions to glean the reason: They are far too complex. To provide improved deterrence and effectiveness, NASAA respectfully requests that Congress review the Commodity Exchange Act's criminal provisions with an eye toward simplification and clarity.

TELEMARKETING FRAUD

NASAA estimates that Americans lose more than \$1 million every hour—roughly \$10 billion a year—to investment scams promoted by phone. The proposed "cooling-off" period for telephone sales to first-time buyers will assist in the effort to protect consumers from high-pressure sales tactics used by unscrupulous promoters of fraudulent commodities-theme investment opportunities.

CONCLUSION

Our financial markets are exerting an ever more ominous presence in the everyday lives of Americans. Like the unfortunate residents of South Carolina helplessly awaiting the onslaught of Hurricane Hugo, did we not all spend the weekend of October 14-15 fearing a repeat of October 19, 1987? Were we not all wondering if more should have been done to prevent such vulnerability and market volatility? The risks associated with commodities trading are legendary. Inequity and dishonesty should not be among those risks. The proposed Futures Trading Practices Act of 1989 will go a long way toward making the exchanges a more fair place to deal and represents a strong signal that commodities fraud will not be tolerated. NASAA strongly urges its enactment.

Thank you.

PREPARED STATEMENT OF DON McELMURY, VICE PRESIDENT, CPC INTERNATIONAL, INC., ARGO, IL

Mr. Chairman and members of the committee, my name is Don McElmury, and I am vice president of CPC International, Inc., in Argo, IL. I am testifying today on

behalf of the National Grain and Feed Association. I presently serve as chairman of NGFA's Commodity Exchange Committee.

The membership of the National Grain and Feed Association (NGFA) encompasses more than 1,300 companies representing some 5,000 facilities that handle and merchandise about two-thirds of all U.S. grain and oilseeds. Our membership is comprised of every segment of the grain and feed industries—country elevators, terminals, merchandisers, exporters, feed manufacturers and primary food processors.

Members of NGFA rely heavily upon the futures markets to hedge purchases and sales of grain and/or grain products. The futures markets of today that play a critical role in agriculture and financial markets, had their beginnings in Chicago more than 100 years ago. It was the grain trade that pioneered these efforts and the major grains were the commodities first traded on these exchanges. In the ensuing decades futures trading has expanded to other commodity sectors where futures have proven themselves repeatedly to be efficient and viable marketing and risk management mechanisms for a wide array of commercial business interests.

The U.S. grain industry is proud of the role it played in the development of commodity futures markets. It is pleased with the expansion that has transpired in the futures industry. The NGFA believes it has been a constructive, positive force during this development and growth process. It is a matter of record that this Association has been a responsible cooperative counselor to the Congress and other branches of government, and has aided government as it has considered legislation and regulatory proposals pertaining to futures markets.

Continuation of viable futures markets is critical to a competitive and efficient marketplace for agriculture. The price discovery mechanism provided by the futures markets benefit the entire national economy as it ensures fair prices are offered to both producers and consumers alike. Just as important to the smooth functioning of a competitive marketplace is the risk management mechanism provided by futures and options markets. Without the opportunity to shift risks via these markets, commercial interests would be unable or unwilling to offer many of the marketing services available today. Futures markets provide the efficiency and risk transferal mechanisms necessary to offer marketing services at the lowest cost possible, which benefit both the producer and ultimate consumer of agricultural commodities. Futures markets are truly the cornerstone of an efficient marketplace.

REAUTHORIZING THE CFTC

This year, 1989, marks the 15th anniversary of the Commodity Futures Trading Commission as an independent body regulating futures trading. While the CFTC has overall regulatory authority over futures trading and is responsible to Congress, the exchanges themselves and self-regulatory organizations also assist in market regulation. We continue to believe that all futures markets should be regulated by an independent regulatory body. Over the years, the CFTC has proven its capability to regulate effectively while allowing markets to perform their intended economic function. For this reason, we support the continued reauthorization of the CFTC. The budgeting and appropriations processes will continue to provide periodic oversight by the Congress and, if unusual circumstances justify, Congress can always use its investigatory powers to review problem areas at its discretion. The CFTC, in our view, has earned the right to become a permanent Federal agency, and should be allowed to devote more of its resources to the actual market surveillance and enforcement activities for which it is intended, rather than having to expend its limited resources in a series of recurring reauthorization processes.

MARGIN-SETTING AUTHORITY

While not under active consideration, the issue of margin-setting authority being vested in one or more government agencies remains a primary concern for our industry. It is our firm belief that margins on futures contracts should continue to come under the sole purview of individual futures exchanges.

There appears to be continuing confusion about futures market margins that cause some to believe there is similarity between margins on securities and margins on futures. The purpose of margins in futures markets is to ensure the financial integrity of all futures buyers and sellers. The purpose of a margin in securities markets is to serve as a downpayment on a credit transaction. The purpose of securities markets is to transfer title from one security owner to another. The function of futures markets is not to transfer title, but rather to transfer price risk. Thus, the futures margin acts much as a performance bond, and depending on price volatility and risk in any given market, is subject to change.

We do not believe any government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any government agency could be sufficiently responsive to changes in margin levels that frequently must be effected in an environment of fast-breaking changes that necessitate rapid, immediately implemented decisions on margin levels. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin-setting responsibilities.

Notwithstanding the current concern over exchange regulation and oversight, from our perspective as commercial hedgers, we believe that commodity markets generally are functioning efficiently under the current regulatory structure. We believe that an over-reaction in the name of regulation could well do considerable damage to efficiently running markets. At the same time adequate self-regulation by exchanges, self-regulatory organizations and the CFTC must be taken very seriously if the self-regulatory structure is to be maintained with confidence. Thus, while the system is performing reasonably well, everyone with interest in the long-term viability of futures markets should welcome the opportunity to consider means of improving market regulation and surveillance to ensure the highest degree of integrity in trading.

DUAL TRADING

A principal issue of these hearings and of S. 1729 is how to best regulate markets to minimize potential abuse of dual trading practices. First, it is vital that Congress recognize the important role dual trading plays in maintaining liquidity in many markets. Adequate liquidity is important to hedgers as the cost of placing hedges can increase tremendously in thin, lightly traded markets. Thus, dual trading is not bad per se; in fact it contributes strongly to the efficiency of futures markets today.

Clearly, however, the use of dual trading can be abused, and close surveillance by the CFTC and exchanges is necessary. To address the dual trading issue, we support an approach giving CFTC specific legislative objectives concerning audit trails, and authorizing the CFTC to write specific rules with stringent penalties for noncompliance.

AUDIT TRAILS

An accurate audit trail is key to the detection of many potential trading abuses. We believe an audit trail should be as accurate as current technology will allow, within reasonable parameters for cost. We also support requirements on tightening surveillance activities during heavy trading periods when abuses are more likely to occur. We believe this approach would provide adequate public protection and preserve the market liquidity necessary for market efficiency and viability.

GOVERNING STRUCTURE

The provision of S. 1729 requiring inclusion of no less than 20 percent of non-members, with an appropriate background, in an exchange's board of directors is supported by our membership. Further, we believe it is important that a diversity of the futures industry be represented on governing boards and disciplinary panels of the exchanges.

CONFLICT OF INTEREST

Our Association continues to believe the governing boards of any contract market always must be sensitive to situations where conflicts of interest, either real or perceived, develop. The exchanges must prevent exploitation of sensitive, nonpublic information by any board member. In addition we support efforts to prevent directors from voting on exchange matters when they, or a close associate are a direct, specific party of interest. The maintenance of the public trust in our markets is an essential element in their successful performance.

BROKERAGE FIRM ACCOUNTABILITY

Our Association opposes futures commission merchants being held liable for the trading violations of floor brokers they may use to execute trades. FCM's seek out floor brokers who provide their customers good order fills and provide the customer honest, reliable trades. There is clearly a strong economic incentive for the FCM to utilize floor brokers who have demonstrated competence, consistency and fairness in trading. But this proposal mandates "due diligence" by FCM's in monitoring floor brokers. The vagueness of the term "due diligence" should make FCM's wary of

groundless litigation by those who are the slightest bit unhappy with a trade. We believe that this change would hamper market liquidity and discourage the use of floor brokers, thus reducing the number of market participants. A dishonest broker is best dealt with by a system which effectively detects abuses and a disciplinary system which appropriately deals and expends with dishonesty.

USER FEES

As a general rule, our Association is not opposed to user fees imposed by government for a service that benefits an identifiable segment of commerce. However, we think it is an uncontested fact that the price discovery function performed by the futures markets provides significant value to all segments of the Nation's economy. Congress should recognize this when determining what portion of the CFTC's operating expenses should be borne by general Treasury revenues and what portion should be covered by user fees. In our judgment it would be inequitable for the Congress to derive from user fees anywhere near all the revenues necessary to cover the CFTC's market surveillance and enforcement expenses.

We do not believe any Federal agency should be granted authority to directly tax those who are regulated by that agency. Obviously any authority for self-sustaining revenues generated by self-ordained taxes imposed by any agency would, in our view, create inequities and inefficiencies that could be mortally damaging to the so-called users subject to such direct taxation.

Across-the-board transaction fees also are inequitable. The preponderance of such transaction fee taxes would be levied upon those who provide market liquidity, commercial hedgers and independent traders. Yet these are not the entities that create the expense load for the CFTC. Constraints resulting from transaction fee taxes could restrain the trading activity of those who are, in a very real sense, the market makers. Transaction fee taxes would thus adversely affect all-important market liquidity.

We would urge that if Congress believes it is necessary to impose user fees to fund the CFTC to improve surveillance, that such user fees be charged directly for such services that are clearly linked to a particular beneficiary of such a service.

BROKER ASSOCIATIONS

Another item addressed by S. 1729 includes a specific restriction on trading between members of broker associations. We understand the intent of this proposal to eliminate potential abuse. But, it is not clear to us that improved audit trail systems, if they are as accurate as required by this legislation, would not provide adequate protection against fraudulent practices that might be committed by "association" members. Artificial restrictions on broker trading between market participants places an additional constraint on efficient marketplace performance. Thus, if there is a means of equivalent protection through better audit trails or some other mechanism that does not add another market restriction it would be preferable.

GENERAL ACCOUNTING OFFICE STUDY ON DELIVERY

In closing, the NGFA would like to commend the Chairman and Ranking Minority Member of this committee for including in S. 1729 a requirement for a study of delivery points for agricultural commodity contracts. Our Association has been intensely studying issues surrounding the market performance of agricultural futures contracts and their viability as hedging and pricing vehicles for commodities. For the last year, we have focused closely on contracts trading at the Chicago Board of Trade and the delivery-mechanism. We have had several meetings with Chicago Board of Trade officials, reviewed an internal study on market performance and have hired a leading academic researcher to perform independent analysis.

We think it is healthy exercise to research and take a closer look at the fundamental relationships between cash and futures markets to make certain they relate as they are intended and operate efficiently. We welcome a study by the General Accounting Office as a means of providing additional information to the discussion of these topics. However, we have concerns about the timing of this study. The Chicago Board of Trade already has established a special committee to make recommendations for changes in areas that will be addressed in this study. This CBOT committee is attempting to arrive at some preliminary recommendations before the end of this calendar year, and these changes likely will be subject of subsequent CFTC rulemaking possibly in late winter or spring of 1990. Thus, it would be helpful if the GAO could offer a preliminary report on its findings after the first 3 months of study to contribute to this decision process in a timely way.

We appreciate the opportunity to present our views on CFTC reauthorization, and pledge our support and cooperation throughout the legislative process. I would be happy to respond to any questions the committee may have.

101ST CONGRESS
1ST SESSION

S. 1729

To amend the Commodity Exchange Act to reauthorize such Act, and for other purposes.

IN THE SENATE OF THE UNITED STATES

OCTOBER 5 (legislative day, SEPTEMBER 18), 1989

Mr. LEAHY (for himself, Mr. LUGAR, and Mr. KERREY) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

A BILL

To amend the Commodity Exchange Act to reauthorize such Act, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

4 (a) SHORT TITLE.—This Act may be cited as the
5 “Futures Trading Practices Act of 1989”.

6 (b) TABLE OF CONTENTS.—The table of contents is as
7 follows:

Sec. 1. Short title; table of contents.

Sec. 2. References to the Commodity Exchange Act.

TITLE I—AUTHORIZATION OF APPROPRIATIONS

Sec. 101. Authorization of appropriations.

TITLE II—FLOOR SURVEILLANCE AND DUAL TRADING

- Sec. 201. Duties of contract markets.
- Sec. 202. Commission oversight; deficiency orders.
- Sec. 203. Oral orders.

TITLE III—BROKER ASSOCIATIONS

- Sec. 301. Trading restrictions.
- Sec. 302. Disclosure.

TITLE IV—GOVERNING STRUCTURE

- Sec. 401. Governing structure.

TITLE V—FLOOR TRADER REGISTRATION

- Sec. 501. Definition of floor trader.
- Sec. 502. Unlawful to act as floor trader or broker without registration.
- Sec. 503. Registration of floor traders.

TITLE VI—PENALTIES

- Sec. 601. Fraudulent transactions.
- Sec. 602. Liability of futures commission merchants.
- Sec. 603. Civil damages.
- Sec. 604. Customer restitution.
- Sec. 605. Increased penalties.
- Sec. 606. Assessment of money penalties; collection of penalties.
- Sec. 607. False information to self-regulatory organizations.
- Sec. 608. Willful violations; false and misleading statements.
- Sec. 609. Complaints against registered persons; class action suits.
- Sec. 610. Penalties study and guidelines.

TITLE VII—ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

- Sec. 701. Definition of foreign futures authority.
- Sec. 702. Subpoena authority.
- Sec. 703. Disclosure by the Commission of information received from foreign futures authorities.
- Sec. 704. Disclosure by the Commission of information to foreign futures authorities.
- Sec. 705. Cooperation with foreign futures authorities.
- Sec. 706. Investigative assistance to foreign futures authorities.
- Sec. 707. Payments from foreign futures authorities.

TITLE VIII—GENERAL PROVISIONS

- Sec. 801. Ethics training for registrants.
- Sec. 802. Undercover operations and enforcement.
- Sec. 803. Access by GAO to information maintained by self-regulatory organizations.
- Sec. 804. Enhancement of registration requirements.
- Sec. 805. Hiring and compensation authority of Commission.
- Sec. 806. Service fees.
- Sec. 807. Appeals by registered futures associations.
- Sec. 808. Telemarketing fraud.
- Sec. 809. Venue; service of process.

Sec. 810. Study of delivery points for agricultural commodity contracts.

TITLE IX—EFFECTIVE DATE

Sec. 901. Effective date.

1 SEC. 2. REFERENCES TO THE COMMODITY EXCHANGE ACT.

2 Except as otherwise specifically provided, whenever in
3 this Act an amendment or repeal is expressed in terms of an
4 amendment to, or repeal of, a section or other provision, the
5 reference shall be considered to be made to a section or other
6 provision of the Commodity Exchange Act (7 U.S.C. 1 et
7 seq.).

8 TITLE I—AUTHORIZATION OF 9 APPROPRIATIONS

10 SEC. 101. AUTHORIZATION OF APPROPRIATIONS.

11 Subsection (d) of section 12 (7 U.S.C. 16(d)) is amended
12 to read as follows:

13 “(d) There are authorized to be appropriated to carry
14 out this Act \$41,000,000 for fiscal year 1990, \$46,700,000
15 for fiscal year 1991, \$54,500,000 for fiscal year 1992,
16 \$63,300,000 for fiscal year 1993, and \$66,100,000 for fiscal
17 year 1994.”.

18 TITLE II—FLOOR SURVEILLANCE 19 AND DUAL TRADING

20 SEC. 201. DUTIES OF CONTRACT MARKETS.

21 Section 5a (7 U.S.C. 7a) is amended—

22 (1) by striking “and” at the end of paragraph
23 (11);

1 (2) by striking the period at the end of paragraph
2 (12) and inserting a semicolon; and

3 (3) by adding at the end the following new para-
4 graph:

5 “(13)(A) maintain and utilize a system to monitor
6 trading to detect and deter violations of this Act relat-
7 ed to the making of trades and the execution of cus-
8 tomer orders on the floor or subject to the rules of
9 such contract market. The system shall include—

10 “(i) physical observation of trading areas;

11 “(ii) audit trail and record keeping systems
12 able to capture essential data on the terms, par-
13 ticipants, and sequence of transactions (including
14 relevant data on unmatched trades and out-
15 trades);

16 “(iii) systems capable of reviewing such data
17 on trades effectively on a regular basis to identify
18 possible violations;

19 “(iv) resources to bring appropriate discipli-
20 nary actions; and

21 “(v) the assessment of meaningful penalties
22 against violators and the referral of appropriate
23 cases to the Commission.

24 “(B) The audit trail system of the contract market
25 shall accurately record—

5

1 “(i) the times of trades in increments of no
2 more than 1 minute in length; and

3 “(ii) the sequence of trades for each floor
4 trader and broker.

5 “(C) Beginning 3 years after the date of enact-
6 ment of this paragraph, the audit trail system of the
7 contract market shall—

8 “(i) record all trades accurately and prompt-
9 ly—

10 “(I) by a source independent of the
11 person making the trade and continually re-
12 corded in the record of the contract market,
13 (including through a mechanism that records
14 the time of execution of each trade automati-
15 cally when entered by such person and
16 records essential data in a form that cannot
17 be altered except in a manner that will leave
18 a complete and independent record of any
19 such alteration); and

20 “(II) with precision adequate to deter-
21 mine the sequence of all trades by each floor
22 trader and floor broker and, to the fullest
23 extent feasible as determined by the Com-
24 mission by rule, the sequence of all trades

1 made by all floor traders and floor brokers;
2 and

3 “(ii) for customer orders, to the extent feasi-
4 ble as determined by the Commission, include a
5 record by a source independent of persons proc-
6 essing or executing such order (including by a
7 mechanism that records such data automatically
8 when entered by such persons in a form that
9 cannot be altered except in a manner that will
10 leave a complete and independent record of any
11 such alteration) of—

12 “(I) the time each such order is re-
13 ceived on the floor of the board of trade and
14 is reported from the floor of the board of
15 trade as executed with precision adequate to
16 determine, for each futures commission mer-
17 chant or floor broker, the sequence in which
18 all such orders are received on and reported
19 from such floor; and

20 “(II) the time each such order is re-
21 ceived by the floor broker for execution with
22 precision adequate to determine the sequence
23 in which such orders are received by each
24 floor broker and, to the fullest extent feasible
25 as determined by the Commission by rule,

1 the interval between the times of receipt and
2 execution of each such order by the floor
3 broker.”.

4 SEC. 202. COMMISSION OVERSIGHT; DEFICIENCY ORDERS.

5 (a) IN GENERAL.—The Act is amended by inserting
6 after section 8d (7 U.S.C. 12d) the following new section:

7 “SEC. 8e. COMMISSION OVERSIGHT; DEFICIENCY ORDERS.

8 “(a) ASSESSMENTS.—Not later than 1 year after the
9 date of enactment of this section, and at least once every 2
10 years thereafter, the Commission shall assess the trade moni-
11 toring system of each contract market implemented pursuant
12 to section 5a(13) to determine its capacity and effectiveness
13 in detecting and deterring violations of this Act.

14 “(b) ORDERS.—

15 “(1) CAUSES.—The Commission shall issue an in-
16 terim order in accordance with paragraph (2) if the
17 Commission finds at any time that a contract market
18 has failed to demonstrate that—

19 “(A) the trade monitoring system implement-
20 ed pursuant to section 5a(13) complies with the
21 audit trail standards of such section;

22 “(B) such system is capable of and is being
23 used to review data on transactions on a regular
24 basis to detect violations related to making trades
25 and executing customer orders on the floor or

1 subject to the rules of such contract market, in-
2 cluding—

3 “(i) all types of violations attributable to
4 dual trading; and

5 “(ii) to the full extent feasible as deter-
6 mined by the Commission, all other types of
7 violations involving the making of trades and
8 the execution of customer orders;

9 “(C) the contract market is utilizing informa-
10 tion gathered through such system on a consistent
11 basis to bring appropriate disciplinary actions
12 against violators;

13 “(D) the contract market is committing re-
14 sources to such system necessary for such system
15 to be effective in detecting and deterring such vio-
16 lations, including adequate staff to develop and
17 prosecute disciplinary actions;

18 “(E) the contract market is assessing mean-
19 ingful penalties for proven violations; or

20 “(F) the contract market is otherwise satisfy-
21 ing the duties of the contract market under sec-
22 tion 5a(13).

23 “(2) CONTENTS.—An order issued under this sub-
24 section shall specify—

1 “(A) the deficiencies the Commission has
2 found in the trade monitoring system of the con-
3 tract market;

4 “(B) corrective action that the contract
5 market must take and an acceptable timetable for
6 such corrective action; and

7 “(C) a date, not less than 20 days from the
8 date of issuance of the interim order, when such
9 order will become final, subject to subsection (d).

10 “(3) REMEDIES.—Such order may require the
11 contract market to—

12 “(A) institute appropriate improvements in
13 its trade monitoring, compliance, or disciplinary
14 systems necessary to bring such systems into
15 compliance with the standards of section 5a(13)
16 and this section;

17 “(B) satisfy stated objective performance cri-
18 teria for compliance with such standards;

19 “(C) employ additional staff, upgrade or re-
20 configure existing systems for collecting or proc-
21 essing relevant data on trading and trader or
22 broker activity, or deploy new such systems;

23 “(D) suspend the privilege of dual trading in
24 such contract market, subject to the standards,

1 exceptions, and duration provisions of subsection
2 (c); or

3 "(E) take any combination of the actions de-
4 scribed in subparagraphs (A) through (D).

5 "(4) REMOVAL.—If the Commission finds, after
6 notice and opportunity for a hearing on the record
7 prior to such order becoming final, that a named offi-
8 cer, director, committee member, or employee of such
9 contract market has willfully—

10 "(A) failed to fulfill the official responsibil-
11 ities of such person with respect to such office;

12 "(B) abused the authority of such person; or

13 "(C) otherwise acted in a manner rendering
14 such person unfit for service in the official position
15 of such person,

16 the Commission may issue an order under this section
17 to remove such officer, director, committee member, or
18 employee.

19 "(5) DESIGNATION AS CONTRACT MARKET.—
20 Notwithstanding section 6, during the period that an
21 interim or final order under this section is in effect, the
22 Commission may refrain from approving any applica-
23 tion for designation as a contract market made by the
24 exchange whose contract market is the subject of such
25 order.

1 “(c) DUAL TRADING.—

2 “(1) IN GENERAL.—Within 1 year after the date
3 of enactment of this section, the Commission shall sus-
4 pend the privilege of dual trading on each contract
5 market, pursuant to an order issued under subsection
6 (b), unless the Commission finds, as part of the first as-
7 sessment made of such contract market under subsec-
8 tion (a) that the contract market has failed to demon-
9 strate that—

10 “(A) the trade monitoring system in place at
11 the contract market fully satisfies the audit trail
12 standards under subsection (b)(1)(A), and other-
13 wise satisfies the standards of subsection (b)(1),
14 such that such system is capable of and is being
15 used to detect and bring appropriate disciplinary
16 actions with regard to violations attributable to
17 dual trading at such contract market; or

18 “(B)(i) there is a substantial likelihood that a
19 dual trading suspension would harm the public in-
20 terest in hedging and price basing at such con-
21 tract market; and

22 “(ii) other remedies under subsection (b) are
23 more appropriate.

24 “(2) EXCEPTIONS.—A Commission order sus-
25 pending dual trading may provide for exceptions to

1 ensure fairness and orderly trading in such contract
2 market (including, where appropriate, a reasonable
3 phase-in period, a limitation of the suspension to speci-
4 fied contracts, exceptions for certain spread transac-
5 tions, corrections of trading errors, or allowing a cus-
6 tomer to designate in writing not less than once annu-
7 ally a named floor broker to execute orders for such
8 customer).

9 “(3) DURATION.—Such suspension shall remain
10 in effect until the Commission makes the finding re-
11 quired under paragraph (1).

12 “(d) RECISSION, MODIFICATION, OR DELAY OF
13 ORDERS.—Before any interim order issued by the Commis-
14 sion under subsection (b) may become final, the Commission
15 shall—

16 “(1) provide the affected contract market with a
17 reasonable opportunity for a hearing in order to peti-
18 tion the Commission to rescind, modify, or delay such
19 order on the ground that—

20 “(A) the deficiencies cited by the Commis-
21 sion have been corrected or are being corrected
22 under an expeditious timetable acceptable to the
23 Commission;

1 “(B) the finding of the Commission that the
2 trade monitoring system of the contract market is
3 deficient is not based on substantial evidence;

4 “(C) the method used by the Commission for
5 assessing the effectiveness or accuracy of the
6 audit trail system of the contract market for pur-
7 poses of paragraphs (1) and (2) of subsection (b)
8 was arbitrary and capricious; or

9 “(D) the timetable proposed by the Commis-
10 sion in its interim order for corrective action by
11 the contract market or the particular corrective
12 action proposed is arbitrary, capricious, or an
13 abuse of discretion; and

14 “(2) rule on such petition.

15 “(e) PENALTIES.—Violation of an order issued under
16 subsection (b) shall be considered a violation of an order of
17 the Commission for purposes of—

18 “(1) establishing liability and assessing penalties
19 against a contract market or any director, officer,
20 agent, or employee thereof under section 6b; or

21 “(2) initiating proceedings under section 5b or
22 6(a).

23 “(f) JUDICIAL REVIEW.—A person aggrieved by an
24 order issued under subsection (b) that has become final may
25 obtain judicial review of the order in the same manner and

1 under the same terms and conditions as are provided in sec-
2 tion 8a(9).

3 “(g) REPORTS.—

4 “(1) REPORTS ON ORDERS.—Within 3 days of
5 the issuance of any interim or final order under this
6 section or a finding under subsection (c)(1) with respect
7 to dual trading, the Commission shall report to the
8 Committee on Agriculture of the House of Representa-
9 tives and the Committee on Agriculture, Nutrition, and
10 Forestry of the Senate on such order or finding, includ-
11 ing a description of—

12 “(A) the contract market involved;

13 “(B) the deficiencies alleged in the trade
14 monitoring system at such contract market; and

15 “(C) the remedies sought by such order.

16 “(2) ANNUAL REPORTS.—The Commission shall
17 report annually to the Committee on Agriculture of the
18 House of Representatives and the Committee on Agri-
19 culture, Nutrition, and Forestry of the Senate on ac-
20 tions taken to carry out this section, including a de-
21 scription of—

22 “(A) the findings of the Commission with re-
23 spect to each trade monitoring system at a con-
24 tract market examined by the Commission during
25 such period; and

1 “(B) any interim or final order issued by the
2 Commission under this section based on deficiencies the Commission has uncovered in such systems, including an analysis of the remedies imposed against, and the corrective action taken by,
3 the contract market pursuant to such order.
4
5
6

7 “(h) DEFINITION OF DUAL TRADING.—As used in this
8 section, the term ‘dual trading’ means the execution of customer orders by a floor broker on any trading day during
9 which the floor broker has executed any trade in the same
10 contract market for—
11

12 “(1) the ~~account~~ of the floor broker;

13 “(2) an account for which the broker has trading
14 discretion; or

15 “(3) an account controlled by a person with whom
16 such broker is subject to trading restrictions under section 4j(3).”
17

18 (b) STUDY.—

19 (1) IN GENERAL.—Not later than 2 years after
20 the date of enactment of this section, the Commodity
21 Futures Trading Commission shall submit to the Committee on Agriculture of the House of Representatives
22 and the Committee on Agriculture, Nutrition, and Forestry of the Senate a report that contains—
23
24

(A) an assessment of the progress of each contract market in developing and implementing systems to record the times of transactions independently, precisely, and completely as required under section 5a(13) of the Commodity Exchange Act (as added by section 201 of this Act); and

(B) recommendations as to whether any extension of time for the completion of such systems or any modification of the standards contained in such section is appropriate.

(2) GAO RECOMMENDATIONS.—The Comptroller General of the United States shall state to Congress the views of the Comptroller General with regard to such report.

SEC. 203. ORAL ORDERS.

(a) IN GENERAL.—Section 4c (7 U.S.C. 6c) is amended by adding at the end the following new subsection:

“(g) The placing of oral orders on contract market floors for member-for-member trades shall be barred unless such orders are made pursuant to rules that the Commission adopts and certifies to Congress will require standards and procedures designed to ensure that such orders are not used to facilitate violations of this Act.”.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall become effective 270 days after the date of enactment of this Act.

TITLE III—BROKER ASSOCIATIONS

SEC. 301. TRADING RESTRICTIONS.

(a) IN GENERAL.—Section 4j (7 U.S.C. 6j) is amended by adding at the end the following new paragraph:

“(3)(A) Except as provided in subparagraph (B), a floor trader or floor broker may not make a trade or execute an order of a customer if such trader or broker knows the opposite party to the transaction to be a floor broker or floor trader with whom such trader or broker has a relationship as—

“(i) a partner in a partnership;

“(ii) an employer or employee;

“(iii) employees of the same employer; or

“(iv) such other affiliation as the Commission may specify by rule.

“(B) Subparagraph (A) shall not apply if the Commission has adopted rules that the Commission certifies to Congress require procedures and standards designed to prevent violations of this Act attributable to the trading described in subparagraph (A).”.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall become effective 270 days after the date of enactment of this Act.

1 **SEC. 302. DISCLOSURE.**

2 Section 5a (7 U.S.C. 7a) (as amended by section 201 of
3 this Act) is further amended by adding at the end the follow-
4 ing new paragraph:

5 “(14) provide for disclosure to the exchange and
6 the Commission of any trade, business, or financial as-
7 sociation, affiliation, partnership, cost-, profit-, or cap-
8 ital-sharing agreement, or other formal or informal
9 such arrangement among or between floor brokers and
10 traders on such contract market;”.

11 **TITLE IV—GOVERNING**
12 **STRUCTURE**

13 **SEC. 401. GOVERNING STRUCTURE.**

14 (a) **CONTRACT MARKETS.**—Section 5a (7 U.S.C. 7a)
15 (as amended by sections 201 and 302 of this Act) is further
16 amended by adding at the end the following new paragraphs:

17 “(15) provide for meaningful representation on the
18 governing board of the contract market’s board of trade
19 of a diversity of interests, including—

20 “(A) futures commission merchants;

21 “(B) producers of, and consumers, proces-
22 sors, distributors, or merchandisers of, principal
23 commodities traded on the exchange;

24 “(C) floor brokers and traders;

1 “(D) participants in a variety of pits or prin-
2 cipal groups of commodities traded on the
3 exchange;

4 “(E) no less than 20 percent of the members
5 of such board, comprised of nonmembers of such
6 contract market’s board of trade with—

7 “(i) expertise in futures trading, or the
8 regulation thereof, in commodities traded
9 through contracts on the exchange; or

10 “(ii) other eminent qualifications making
11 such person capable of participating in and
12 contributing to board deliberations;

13 “(16)(A) provide on all major disciplinary commit-
14 tees for a diversity of membership sufficient to ensure
15 fairness and to prevent special treatment or preference
16 for any person in the conduct of disciplinary proceed-
17 ings and the assessment of penalties.

18 “(B) A major disciplinary committee hearing a
19 disciplinary matter shall include—

20 “(i) qualified persons representing segments
21 of the exchange membership other than that of
22 the subject of the proceeding; and

23 “(ii) where appropriate to carry out the pur-
24 poses of this paragraph, qualified persons who are
25 not members of the exchange.

1 “(C) If a contract market takes final disciplinary
2 action against a member for a violation that involves
3 the execution of a customer order and results in finan-
4 cial harm to such customer, the contract market shall
5 promptly inform the ultimate customer of the discipli-
6 nary action and the principal facts thereof. The Com-
7 mission and futures commission merchant carrying the
8 account for such customer shall cooperate with the
9 contract market in carrying out its duties under this
10 paragraph.

11 “(17)(A) provide for the avoidance of conflict of
12 interest in all deliberations by the governing board and
13 any disciplinary and oversight committees.

14 “(B) The contract market shall adopt rules that
15 require that a board or committee member abstain from
16 participation in voting and confidential deliberations on
17 an issue if the member, an affiliated firm or business, a
18 family member, or any other individual with whom the
19 member has a business or employment relationship is,
20 to the knowledge of such member, a specific and actual
21 party in interest to the issue before the board.

22 “(C) Notwithstanding any other provision of this
23 paragraph, in adopting any contract market rule or
24 order that is likely to affect prices in any actively trad-
25 ing contract market (including any motion to adopt an

1 emergency measure for a nonphysical emergency), the
2 contract market shall ensure that—

3 “(i) any party with access to material, non-
4 public information about such deliberations gained
5 through the position of the party as an exchange
6 employee or official shall be prevented from—

7 “(I) trading, directly or indirectly, in a
8 manner to take improper advantage of such
9 information; or

10 “(II) transmitting such information to
11 any other party, except as necessary for the
12 performance of official duties; and

13 “(ii) prior to such deliberations, each partici-
14 pant shall disclose to the board or committee the
15 position of the participant in the contract market
16 under discussion, along with all positions held in
17 accounts at the affiliated firm of the participant of
18 which the participant is aware, in such form as
19 will provide effective information to the board
20 while maintaining appropriate confidentiality of
21 trading information.

22 “(D) If any board or committee member disclosing
23 such positions under subparagraph (C)(ii) participates in
24 such deliberations, the minutes of such deliberations
25 shall clearly reflect this fact; and

1 “(18) provide that no member found by the Com-
2 mission, a contract market, a registered futures asso-
3 ciation, or a court of competent jurisdiction to have
4 violated this Act or any other provision of law that
5 would reflect on the fitness of the member to serve in
6 a fiduciary position, may serve on any contract market
7 oversight or disciplinary panel for an appropriate
8 period (as defined by Commission rule).”.

9 (b) REGISTERED FUTURES ASSOCIATIONS.—Section
10 17(b) (7 U.S.C. 21(b)) is amended by adding at the end the
11 following new paragraphs:

12 “(11) such association provides for meaningful
13 representation on the governing board of such associa-
14 tion of a diversity of membership interests and provides
15 that no less than 20 percent of the members of such
16 board be comprised of qualified nonmembers of such
17 association.

18 “(12)(A) such association provides on all major
19 disciplinary committees for a diversity of membership
20 sufficient to ensure fairness and to prevent special
21 treatment or preference for any person in the conduct
22 of disciplinary proceedings and the assessment of
23 penalties.

24 “(B) A major disciplinary committee hearing a
25 disciplinary matter shall include—

1 “(i) qualified persons representing segments
2 of the association membership other than that of
3 the subject of the proceeding; and

4 “(ii) where appropriate to carry out the pur-
5 poses of this paragraph, qualified persons who are
6 not members of the association.”.

7 (c) IMPLEMENTATION.—Not later than 270 days after
8 the date of enactment of this Act, the Commodity Futures
9 Trading Commission shall adopt such rules as are necessary
10 to carry out the amendments made by subsections (a) and (b),
11 including rules that—

12 (1) specify membership categories that shall be
13 represented on disciplinary panels;

14 (2) define “major disciplinary committee” for pur-
15 poses of sections 5a(16) and 17(b)(12) of the Commodity
16 Exchange Act (as added by subsections (a) and (b),
17 respectively);

18 (3) specify the conditions under which such panels
19 shall include qualified persons who are not members of
20 the exchange or association, which shall include at a
21 minimum—

22 (A) any disciplinary action where the subject
23 of such action is a member of the contract market
24 or association governing board or of any major

1 disciplinary committee of such contract market or
2 association; and

3 (B) any disciplinary action involving a claim
4 that the subject of such action manipulated or at-
5 tempted to manipulate the price of a commodity
6 or future or option;

7 (4) establish procedures for informing customers of
8 disciplinary actions in accordance with section
9 5a(16)(C) of such Act;

10 (5) provide guidance in determining what are ac-
11 ceptable forms of and procedures for the disclosure by
12 members of contract market boards or committees
13 under section 5a(17)(C) of such Act; and

14 (6) define the appropriate periods during which
15 members found to have violated relevant laws may not
16 serve on exchange oversight or disciplinary panels
17 under section 5a(18) of such Act.

18 **TITLE V—FLOOR TRADER** 19 **REGISTRATION**

20 **SEC. 501. DEFINITION OF FLOOR TRADER.**

21 Section 2(a)(1)(A) (7 U.S.C. 2, 4) is amended by adding
22 at the end the following new sentence: "The term 'floor
23 trader' shall mean any person who, in or surrounding any
24 'pit', 'ring', 'post', or other place provided by a contract
25 market for the meeting of persons similarly engaged, pur-

1 chases or sells solely for such person's own account any com-
2 modity for future delivery on or subject to the rules of any
3 contract market."

4 SEC. 502. UNLAWFUL TO ACT AS FLOOR TRADER OR BROKER
5 WITHOUT REGISTRATION.

6 (a) IN GENERAL.—Section 4e (7 U.S.C. 6e) is amended
7 to read as follows:

8 "SEC. 4e. UNLAWFUL TO ACT AS FLOOR TRADER OR BROKER
9 WITHOUT REGISTRATION.

10 "It shall be unlawful for any person to act as—

11 "(1) a floor trader in executing purchases and
12 sales; or

13 "(2) a floor broker in executing an order for the
14 purchase or sale of any commodity for future delivery,
15 or involving any contract of sale of any commodity for
16 future delivery, on or subject to the rules of any con-
17 tract market,

18 unless such person shall have registered, under this Act, with
19 the Commission as such floor trader or floor broker and such
20 registration shall not have expired nor been suspended nor
21 revoked."

22 (b) EFFECTIVE DATE.—The amendment made by sub-
23 section (a) shall become effective 180 days after the date of
24 enactment of this Act.

1 SEC. 503. REGISTRATION OF FLOOR TRADERS.

2 The Act is amended—

3 (1) in sections 4f(1), 4g(1), and 6d(1) (7 U.S.C.
4 6f(1), 6g(1), 13a-2(1)), by striking “or floor broker”
5 and inserting “floor broker, or floor trader”;

6 (2) in section 6d(8)(A) (7 U.S.C. 13a-2(8)(A)), by
7 inserting “, floor trader,” after “floor broker”;

8 (3) in section 8a(1), (7 U.S.C. 12a(1)), by striking
9 “and floor brokers” and inserting “floor brokers, and
10 floor traders”; and

11 (4) in sections 8a(2)(C)(i), 8a(2)(D)(ii), and
12 8a(3)(E)(ii) (7 U.S.C. 12a(2)(C)(i), 12a(2)(D)(ii), and
13 12a(3)(E)(ii)), by inserting “floor trader,” after “floor
14 broker,”.

15 TITLE VI—PENALTIES

16 SEC. 601. FRAUDULENT TRANSACTIONS.

17 The first paragraph of section 4b (7 U.S.C. 6b) is
18 amended—

19 (1) by striking “or” at the end of subparagraph
20 (C);

21 (2) by striking the period at the end of subpara-
22 graph (D) and inserting “; or”; and

23 (3) by adding at the end the following new sub-
24 paragraph:

25 “(E) to engage in any transaction, practice, or
26 course of business that operates as a fraud or deceit on

1 any person, or to employ any device, scheme, or arti-
2 fice to defraud any person.”.

3 SEC. 602. LIABILITY OF FUTURES COMMISSION MERCHANTS.

4 Section 4d (7 U.S.C. 6d) is amended—

5 (1) by inserting “(a)” after the section designation;
6 and

7 (2) by adding at the end the following new sub-
8 section:

9 “(b)(1) In any action brought under section 14(a) or
10 22(a), or under procedures provided by a contract market or
11 a registered futures association under section 5a(11) or
12 17(b)(11), if such action arises from a violation in the making
13 of a trade or execution of an order on the floor or subject to
14 the rules of a contract market, a futures commission mer-
15 chant that selected or contracted with a floor broker (who is
16 not an employee of such futures commission merchant) to
17 conduct the trade or execute the order from which such claim
18 arose shall be considered the principal of such floor broker,
19 and the floor broker shall be considered the agent of such
20 futures commission merchant, if both the floor broker and the
21 futures commission merchants are named as defendants in
22 such action, for purposes of assessing—

23 “(A) any award of damages proximately caused
24 by such violation; and

1 “(B) if such futures commission merchant willfully
2 and intentionally failed to exercise due diligence in se-
3 lecting the floor broker or monitoring the execution of
4 the customer order at issue in such action, any award
5 of punitive or exemplary damages based on such claim.

6 “(2) Nothing in this subsection shall affect or limit the
7 liability of a futures commission merchant for the act, omis-
8 sion, or failure of an employee acting for such futures com-
9 mission merchant pursuant to section 2(a)(1)(A).”.

10 SEC. 603. CIVIL DAMAGES.

11 (a) DUTIES OF CONTRACT MARKETS.—Section 5a(11)
12 (7 U.S.C. 7a(11)) is amended—

13 (1) by striking “(i)” and inserting “(A)”;

14 (2) by striking “voluntary and (ii)” and inserting
15 “voluntary, (B)”;

16 (3) by inserting after “market” the following: “,
17 and (C) in the case of a claim arising from a violation
18 in the making of a trade or the execution of an order
19 on the floor or subject to the rules of a contract
20 market, such procedure shall provide, to the extent ap-
21 propriate, for payment to a customer of punitive or ex-
22 emplary damages in addition to losses proximately
23 caused by the violation”.

24 (b) COMPLAINTS AGAINST REGISTERED PERSONS.—
25 Section 14(a) (7 U.S.C. 18(a)) is amended by striking

1 "awarding actual damages proximately caused by such viola-
2 tion" and inserting "awarding—

3 "(1) actual damages proximately caused by such
4 violation; and

5 "(2) in the case of any action arising from a will-
6 ful and intentional violation involving the making of a
7 trade or execution of an order on the floor or subject to
8 the rules of a contract market, punitive or exemplary
9 damages equal to no more than two times the amount
10 of such actual damages".

11 (c) REGISTERED FUTURES ASSOCIATIONS.—Section
12 17(b)(10) is amended—

13 (1) by striking "(i)" and inserting "(A)";

14 (2) by striking "voluntary and (ii)" and inserting
15 "voluntary, (B)"; and

16 (3) by inserting after "market" the following: "
17 and (C) in the case of a claim arising from a violation
18 in the making of a trade or the execution of an order
19 on the floor or subject to the rules of a contract
20 market, such procedure shall provide, to the extent ap-
21 propriate, for payment to a customer of punitive or ex-
22 emplary damages in addition to losses proximately
23 caused by the violation".

1 (d) PRIVATE RIGHTS OF ACTION.—Section 22(a) (7
2 U.S.C. 25(a)) is amended by adding at the end the following
3 new paragraph:

4 “(3) In any action arising from a willful and intentional
5 violation in the making of a trade or execution of an order on
6 the floor or subject to the rules of a contract market, the
7 person referred to in paragraph (1) shall be liable for—

8 “(A) actual damages proximately caused by such
9 violation; and

10 “(B) punitive or exemplary damages equal to no
11 more than two times the amount of such actual
12 damages.”.

13 SEC. 604. CUSTOMER RESTITUTION.

14 The tenth sentence of section 6(b) (7 U.S.C. 9) is
15 amended—

16 (1) by inserting “(1)” after “may” the first place
17 it appears;

18 (2) by striking “and, if” and inserting “(2) if”;

19 (3) by striking “may suspend” and inserting
20 “suspend”;

21 (4) by striking “and may” and inserting “(3)”;
22 and

23 (5) by inserting before the period the following:

24 “and (4) require restitution to customers of damages
25 proximately caused by such violation”.

1 SEC. 605. INCREASED PENALTIES.

2 (a) IN GENERAL.—Sections 6(b), 6(c), and 9 (7 U.S.C.
3 9, 13b, and 13) are each amended by striking “\$100,000”
4 each place it appears and inserting “the higher of \$100,000
5 or triple the monetary gain to such person”.

6 (b) NONENFORCEMENT OF RULES OF GOVERNMENT
7 OR OTHER VIOLATIONS.—Section 6b (7 U.S.C. 13a) is
8 amended—

9 (1) by striking “\$100,000” each place it appears
10 and inserting “\$500,000”; and

11 (2) in the last sentence, by striking “the appropri-
12 ateness of such penalty to the net worth of the offend-
13 ing person and”.

14 SEC. 606. ASSESSMENT OF MONEY PENALTIES; COLLECTION
15 OF PENALTIES.

16 Subsection (d) of section 6 (7 U.S.C. 9a) is amended to
17 read as follows:

18 “(d)(1) In determining the amount of the money penalty
19 assessed under subsection (b), the Commission shall consider
20 the appropriateness of such penalty to the gravity of the
21 violation.

22 “(2)(A) Except as provided in subparagraphs (B) and
23 (C), if a money penalty is assessed against a person under
24 subsection (b), such person shall beginning 15 days after such
25 assessment—

1 “(i) be prohibited automatically from trading on
2 all contract markets; and

3 “(ii) if the person is registered with the Commis-
4 sion, be suspended automatically,

5 until such person shows to the satisfaction of the Commission
6 that payment of such amount, with interest on such payment
7 to the date of payment, has been made.

8 “(B) Subparagraph (A) shall not apply if the person on
9 whom the penalty is assessed shows to the satisfaction of the
10 Commission, within 15 days from the expiration of the period
11 allowed for payment of such penalty, that—

12 “(i) an appeal as authorized by subsection (b) has
13 been taken; or

14 “(ii) payment of the full amount of the penalty has
15 been made.

16 “(C) If on appeal the Commission prevails or if the
17 appeal is dismissed, the automatic prohibition against trading
18 and suspension of registration imposed under subparagraph
19 (A) shall become effective on the expiration of 30 days from
20 the date of judgment on the appeal.

21 “(3) If the person on whom a money penalty is imposed
22 under subsection (b) fails to pay such penalty after the lapse
23 of the period allowed for appeal or after the affirmance of
24 such penalty, the Commission shall refer the matter to the

1 Attorney General who shall recover such penalty by action in
2 the appropriate United States district court.”.

3 **SEC. 607. FALSE INFORMATION TO SELF-REGULATORY ORGA-**
4 **NIZATIONS.**

5 Section 9 (7 U.S.C. 13) is amended by adding at the end
6 the following new subsection:

7 “(g) It shall be a felony punishable by a fine of not more
8 than \$100,000 or imprisonment for not more than 5 years, or
9 both, together with the costs of prosecution, for any person
10 knowingly and willfully to falsify, conceal, or cover up by any
11 trick, scheme, or artifice a material fact, make any false, ficti-
12 tious, or fraudulent statements or representations, or make or
13 use any false writing or document knowing the same to con-
14 tain any false, fictitious, or fraudulent statement or entry to a
15 contract market, board of trade, or futures association desig-
16 nated or registered under this Act acting in furtherance of its
17 official duties under this Act.”.

18 **SEC. 608. WILLFUL VIOLATIONS; FALSE AND MISLEADING**
19 **STATEMENTS.**

20 Section 9 (7 U.S.C. 13) (as amended by section 607 of
21 this Act) is further amended by adding at the end the follow-
22 ing new subsection:

23 “(h) Any person who willfully violates any provision of
24 this Act, or any rule or regulation thereunder the violation of
25 which is made unlawful or the observance of which is re-

1 quired under the terms of this Act, or any person who willful-
2 ly and knowingly makes, or causes to be made, any state-
3 ment in any application, report, or document required to be
4 filed under this Act or any rule or regulation thereunder or
5 any undertaking contained in a registration statement re-
6 quired under this Act, or by any contract market or regis-
7 tered futures association in connection with an application for
8 membership or participation therein or to become associated
9 with a member thereof, which statement was false or mis-
10 leading with respect to any material fact, shall on conviction
11 be fined not more than \$500,000, or imprisoned not more
12 than 5 years, or both, except that no person shall be subject
13 to imprisonment under this subsection for the violation of any
14 rule or regulation if the person proves that the person had no
15 knowledge of such rule or regulation.”.

16 SEC. 609. COMPLAINTS AGAINST REGISTERED PERSONS;
17 CLASS ACTION SUITS.

18 Section 14(a) (7 U.S.C. 18(a)) (as amended by section
19 603(b) of this Act) is further amended—

20 (1) by redesignating paragraphs (1) and (2) as sub-
21 paragraphs (A) and (B), respectively;

22 (2) by inserting “(1)” after the subsection designa-
23 tion; and

24 (3) by adding at the end the following new para-
25 graph:

1 “(2)(A) An action may be brought under this subsection
2 by any one or more persons described in this subsection for
3 and in behalf of such person or persons and other persons
4 similarly situated, if the Commission permits such actions
5 pursuant to a final rule issued by the Commission.

6 “(B) Not later than 270 days after the date of enact-
7 ment of this paragraph, the Commission shall propose and
8 publish for public comment such rules as are necessary to
9 carry out subparagraph (A). In developing such rules, the
10 Commission shall consider the potential impact of such ac-
11 tions on resources available to the reparations system estab-
12 lished under this Act and the relative merits of bringing such
13 actions in Federal court.”.

14 **SEC. 610. PENALTIES STUDY AND GUIDELINES.**

15 (a) **STUDY.**—The Commodity Futures Trading Commis-
16 sion shall study the penalties the Commission imposes
17 against persons found to have violated the Commodity Ex-
18 change Act (7 U.S.C. 1 et seq.) and the penalties imposed by
19 contract markets against persons found to have violated their
20 respective rules established under such Act.

21 (b) **REPORT.**—Not later than 2 years after the date of
22 enactment of this Act, the Commission shall submit to the
23 Committee on Agriculture of the House of Representatives
24 and the Committee on Agriculture, Nutrition, and Forestry of

1 the Senate a report that describes the results of the study
2 conducted under subsection (a). The report shall—

3 (1) include an analysis of whether systematic dif-
4 ferences exist among penalties imposed by various con-
5 tract markets for similar offenses, and, if so, the causes
6 of such differences;

7 (2) propose industry-wide guidelines or rules to
8 make penalty levels among exchanges consistent, in-
9 cluding, if appropriate, minimum penalties or penalty
10 ranges for various offenses; and

11 (3) propose guidelines or rules to make Commis-
12 sion penalty levels consistent, including, if appropriate,
13 minimum penalties or penalty ranges for various
14 offenses.

15 **TITLE VII—ASSISTANCE TO FOR-** 16 **EIGN FUTURES AUTHORITIES**

17 **SEC. 701. DEFINITION OF FOREIGN FUTURES AUTHORITY.**

18 Section 2(a)(1)(A) (7 U.S.C. 2, 4) (as amended by sec-
19 tion 501 of this Act) is further amended by adding at the end
20 the following new sentence: "The term 'foreign futures au-
21 thority' means any foreign government, or any department,
22 agency, governmental body, or regulatory organization em-
23 powered by a foreign government to administer or enforce a
24 law, rule, or regulation as it relates to a futures or options
25 matter, or any department or agency of a political subdivision

1 of a foreign government empowered to administer or enforce
2 a law, rule, or regulation as it relates to a futures or options
3 matter.”.

4 **SEC. 702. SUBPOENA AUTHORITY.**

5 The third sentence of section 6(b) (7 U.S.C. 15) is
6 amended—

7 (1) by striking “Act and” and inserting “Act,”;
8 and

9 (2) by striking “Act,” and inserting “Act, and for
10 the purpose of any action taken under section 12(g),”.

11 **SEC. 703. DISCLOSURE BY THE COMMISSION OF INFORMA-**
12 **TION RECEIVED FROM FOREIGN FUTURES**
13 **AUTHORITIES.**

14 Section 8(b) (7 U.S.C. 12(b)) is amended by adding at
15 the end the following new sentence: “Nothing in this subsec-
16 tion shall apply to the disclosure of data or information ob-
17 tained by the Commission from a foreign futures authority.”.

18 **SEC. 704. DISCLOSURE BY THE COMMISSION OF INFORMA-**
19 **TION TO FOREIGN FUTURES AUTHORITIES.**

20 Section 8(e) (7 U.S.C. 12(e)) is amended—

21 (1) in the fifth sentence—

22 (A) by inserting after “jurisdiction,” the first
23 place it appears the following: “any foreign fu-
24 tures authority,”; and

1 (B) by inserting after "such" the following:

2 "foreign futures authority,"; and

3 (2) in the last sentence—

4 (A) by inserting after "information to a" the

5 following: "foreign futures authority or to a";

6 (B) by inserting after "disclosed by such" the

7 following: "foreign futures authority,"; and

8 (C) by inserting after "or agency thereof"

9 the following: "or foreign futures authority".

10 SEC. 705. COOPERATION WITH FOREIGN FUTURES AUTHORI-
11 TIES.

12 Section 12(a) (7 U.S.C. 16(a)) is amended by inserting
13 after "thereof," the following: "any foreign futures authority,
14 any department or agency of a foreign government or politi-
15 cal subdivision thereof,".

16 SEC. 706. INVESTIGATIVE ASSISTANCE TO FOREIGN FUTURES
17 AUTHORITIES.

18 Section 12 (7 U.S.C. 16) is amended by adding at the
19 end the following new subsection:

20 "(f)(1) On request from a foreign futures authority, the
21 Commission may, in its discretion, provide assistance in ac-
22 cordance with this section if the requesting authority states
23 that the requesting authority is conducting an investigation
24 that it considers necessary to determine whether any person
25 has violated, is violating, or is about to violate any law, rule,

1 or regulation relating to a futures or options matter that the
2 requesting authority administers or enforces.

3 “(2) The Commission may conduct such investigation as
4 the Commission considers necessary to collect information
5 and evidence pertinent to the request for assistance.

6 “(3) Such assistance may be provided without regard to
7 whether the facts stated in the request would also constitute
8 a violation of a law of the United States.

9 “(4) In deciding whether to provide assistance under
10 this subsection, the Commission shall consider whether—

11 “(A) the requesting authority has agreed to pro-
12 vide reciprocal assistance to the Commission in futures
13 and options matters; and

14 “(B) compliance with the request would prejudice
15 the public interest of the United States.”.

16 **SEC. 707. PAYMENTS FROM FOREIGN FUTURES AUTHORITIES.**

17 Section 12 (7 U.S.C. 16) (as amended by section 706 of
18 this Act) is further amended by adding at the end the follow-
19 ing new section:

20 “(g) Notwithstanding any other provision of law, the
21 Commission may accept payment and reimbursement, in cash
22 or in kind, from a foreign futures authority, or made on behalf
23 of such authority, for necessary expenses incurred by the
24 Commission (including its members and employees) in carry-
25 ing out any investigation conducted pursuant to this section

1 or in providing any other assistance to a foreign futures au-
2 thority. Any payment or reimbursement accepted under this
3 subsection shall be considered a reimbursement to the appro-
4 priated funds of the Commission.”.

5 TITLE VIII—GENERAL 6 PROVISIONS

7 SEC. 801. ETHICS TRAINING FOR REGISTRANTS.

8 (a) MANDATORY TRAINING FOR REGISTRANTS.—Sec-
9 tion 4p (7 U.S.C. 6p) is amended—

10 (1) by inserting “(a)” after the section designation;

11 and

12 (2) by adding at the end the following new sub-
13 section:

14 “(b) The Commission shall issue regulations to require
15 new registrants, within 6 months after receiving such regis-
16 tration, to attend a training session, and all other registrants
17—to attend periodic training sessions, to ensure that registrants
18 understand their responsibilities to the public under this Act,
19 including responsibilities to observe just and equitable princi-
20 ples of trade, any rule or regulation of the Commission, any
21 rule of any appropriate contract market, registered futures
22 association, or other self-regulatory organization, or any
23 other applicable Federal or State law, rule, or regulation.”.

24 (b) REGULATIONS.—The Commodity Futures Trading
25 Commission shall issue the regulations required by section

1 4p(b) of the Commodity Exchange Act (as added by subsec-
2 tion (a) of this section) no later than 270 days after the date
3 of enactment of this Act.

4 SEC. 802. UNDERCOVER OPERATIONS AND ENFORCEMENT.

5 Section 8(a) (7 U.S.C. 12(a)) is amended—

6 (1) by designating the first and second sentences
7 as paragraphs (1) and (2), respectively; and

8 (2) by adding at the end the following new para-
9 graph:

10 “(3)(A) Notwithstanding sections 2(a)(7) and 9(d) of this
11 Act, section 5945 of title 5, United States Code, sections
12 1341, 3302(b), and 9102 of title 31 of such Code, and sec-
13 tions 254 and 255 of title 41 of such Code, the Commission
14 may, by order, authorize specified employees to conduct un-
15 dercover investigations where the Commission has reason to
16 believe that violations of this Act may have occurred, may be
17 occurring, or may be about to occur to ascertain whether
18 proceedings under this Act with respect to such violations are
19 appropriate.

20 “(B) The Commission shall notify the Attorney General
21 and other appropriate Federal or State law enforcement offi-
22 cials before initiating an investigation under this paragraph.
23 The Commission shall not adopt an order under subpara-
24 graph (A) unless the Commission has first made a request to
25 the Attorney General that the Attorney General conduct the

1 proposed undercover investigation and the Attorney General
2 has declined to do so.

3 “(C) In conducting such investigations, the Commission
4 may coordinate with and seek the assistance of other Federal
5 or State law enforcement authorities, contract markets, reg-
6 istrants, or other private parties as the Commission considers
7 appropriate.

8 “(D) During the conduct of an investigation under this
9 paragraph, the employees conducting such investigation shall
10 report to the Chairman of the Commission no less than once
11 every 90 days on the progress of such investigation.

12 “(E) A Commission employee who participates in a vio-
13 lation of this Act in the course and as a necessary element of
14 an undercover investigation authorized under this paragraph
15 shall not be liable in any action or proceeding arising from
16 such violation.

17 “(F) The Commission shall by rule adopt procedures
18 governing the conduct of such investigations that are similar
19 to guidelines adopted by the Attorney General for the con-
20 duct of undercover investigations.”.

21 **SEC. 803. ACCESS BY GAO TO INFORMATION MAINTAINED BY**
22 **SELF-REGULATORY ORGANIZATIONS.**

23 Section 8(i) (7 U.S.C. 12(i)) is amended—

24 (1) by inserting “(1)” after the subsection designa-
25 tion;

1 (2) by striking “, except” and all that follows
2 through the period at the end of the subsection and in-
3 serting a period; and

4 (3) by adding at the end the following new para-
5 graphs:

6 “(2) For the purpose of conducting reviews and audits
7 under paragraph (1), the Comptroller General and any duly
8 authorized representative shall, under the terms and condi-
9 tions applicable to the Commission, have access to and the
10 right to examine all records and other recorded information,
11 in any form, and to examine any property that is within the
12 possession and control of any contract market, clearinghouse,
13 or registered futures association within the jurisdiction of the
14 Commission, or of a firm that provides computer services to
15 such self-regulatory organization or the Commission to the
16 extent the records, information or property relate to such
17 computer services.

18 “(3) The Comptroller General shall maintain the same
19 level of confidentiality for information made available under
20 this paragraph as the Commission. Officers and employees of
21 the General Accounting Office shall be subject to the same
22 statutory penalties for unauthorized disclosure or use as offi-
23 cers and employees of the Commission.

24 “(4) The Comptroller General shall not include in re-
25 ports data and information that would separately disclose the

1 business transactions or market positions of any person and
2 trade secrets or names of customers, although such data shall
3 be provided on request by any committee of either House of
4 Congress acting within the scope of its jurisdiction.

5 “(5) The Comptroller General’s right of access under
6 this section shall be enforceable pursuant to section 716 of
7 title 31, United States Code.”.

8 **SEC. 804. ENHANCEMENT OF REGISTRATION REQUIREMENTS.**

9 (a) **INJUNCTIONS.**—Clause (ii) of section 8a(2)(C) (7
10 U.S.C. 12a(2)(C)(ii)) is amended to read as follows: “(ii) en-
11 gaging in or continuing any activity where such activity in-
12 volves embezzlement, theft, extortion, fraud, fraudulent con-
13 version, misappropriation of funds, securities or property, for-
14 gery, counterfeiting, false pretenses, bribery, gambling, or
15 any transaction in or advice concerning contracts of sale of a
16 commodity for future delivery, concerning matters subject to
17 Commission regulation under section 4c or 19, or concerning
18 securities”.

19 (b) **CERTAIN VIOLATIONS OF LAW.**—Section
20 8a(2)(D)(iv) is amended—

- 21 (1) by inserting “1001,” after “152,”;
22 (2) by striking “or” after “1342,”;
23 (3) by inserting “1503, 1623, 1961, 1962, 1963,
24 or 2314,” after “1343,”; and

1 (4) by inserting “, or section 7201 or 7206 of the
2 Internal Revenue Code of 1986” after “Code”.

3 (c) OTHER VIOLATIONS OF LAW.—Section 8a(2)(E) is
4 amended—

5 (1) by striking “by any court of competent juris-
6 diction,” and inserting “in a proceeding brought”; and

7 (2) in clause (i), by inserting “chapter 96 of title
8 18 of the United States Code,” after “1977,”.

9 (d) REGISTRATION REVOCATION BASED ON INACCU-
10 RATE STATEMENTS.—Section 8a(2)(G) is amended—

11 (1) by striking “subparagraphs (A) through (F) of
12 this paragraph,” and inserting “this paragraph and
13 paragraph (3),”;

14 (2) by striking “material” the first place it ap-
15 pears and inserting “materially”; and

16 (3) by striking “application” and inserting “appli-
17 cation or any update thereto”.

18 (e) GENERAL FELONY CONVICTIONS.—Section
19 8a(3)(D) is amended—

20 (1) by inserting “pleaded guilty to or” after
21 “person”;

22 (2) by inserting a comma after “section” the first
23 place it appears;

24 (3) by striking “within ten years preceding the
25 filing of the application or at any time thereafter,”;

1 (4) by striking “, including a felony”; and

2 (5) by striking “, more than” and inserting “more
3 than”.

4 (f) SPECIAL FELONY CONVICTIONS.—Section 8a(3)(E)
5 is amended—

6 (1) by inserting “pleaded guilty to or” after
7 “person”;

8 (2) by striking “within ten years preceding the
9 filing of the application for registration or at any time
10 thereafter”; and

11 (3) in clause (iv), by inserting “, or section 7203,
12 7204, 7205, or 7207 of the Internal Revenue Code of
13 1986” after “Code”.

14 (g) REGISTRATION DENIED OR CONDITIONED BASED
15 ON INACCURATE STATEMENTS.—Section 8a(3)(G) is
16 amended—

17 (1) by striking “material” the first place it ap-
18 pears and inserting “materially”;

19 (2) by striking the comma after “application”;

20 (3) by inserting “or any update thereto,” after
21 “application”;

22 (4) by striking “thereunder, or” and inserting
23 “thereunder,”; and

24 (5) by inserting “, or in any registration disqualifi-
25 cation proceeding” after “before the Commission”.

1 (h) NON-FEDERAL CRIMINAL CONDUCT.—Section
2 8a(3)(H) is amended by inserting “, in a United States mili-
3 tary court,” after “State court”.

4 (i) EXISTING RESTRICTIONS ON MEMBERSHIPS.—Sec-
5 tion 8a(3)(J) is amended—

6 (1) by striking “or” after “association,” the first
7 place it appears;

8 (2) by inserting “or any foreign regulatory body
9 that the Commission recognizes as having a compara-
10 ble regulatory program,” after “organization,” the first
11 place it appears;

12 (3) by striking “or” after “association,” the
13 second place it appears; and

14 (4) striking “organization;” and inserting “organi-
15 zation, or foreign regulatory body;”.

16 SEC. 805. HIRING AND COMPENSATION AUTHORITY OF COM-
17 MISSION.

18 (a) IN GENERAL.—Section 12(b) (7 U.S.C. 16(b)) is
19 amended—

20 (1) by designating the first through third sentences
21 as paragraphs (1) through (3), respectively; and

22 (2) by adding at the end the following:

23 “(4)(A) The Commission shall fix the compensation and
24 number of, and appoint and direct, employees of the Commis-
25 sion. Rates of basic pay for employees of the Commission

1 may be set and adjusted by the Commission without regard
2 to the provisions of chapter 51, subchapters III and VIII of
3 chapter 53, and chapter 54 of title 5, United States Code.

4 “(B) The Commission may provide additional compensa-
5 tion and benefits to employees of the Commission if the same
6 type of compensation or benefits are then being provided by
7 any Federal bank regulatory agency or, if not then being pro-
8 vided, could be provided by such an agency under applicable
9 provisions of law, rule, or regulation. In setting and adjusting
10 the total amount of compensation and benefits for employees
11 of the Commission, the Commission shall seek to maintain
12 comparability with the Federal bank regulatory agencies. For
13 the purpose of this paragraph, the term ‘Federal bank regula-
14 tory agency’ means the Board of Governors of the Federal
15 Reserve System, the Office of the Comptroller of the Curren-
16 cy, the Federal Deposit Insurance Corporation, the Office of
17 Thrift Supervision, and the National Credit Union Adminis-
18 tration Board.”.

19 (b) REGULATIONS.—The Commodity Futures Trading
20 Commission shall issue and submit to Congress proposed reg-
21 ulations to carry out the amendment made by subsection (a)
22 of this section.

23 (c) EFFECTIVE DATE.—Such amendment and regula-
24 tions shall become effective 30 legislative days or 90 calendar

1 days, whichever is later, after submission of such regulations
2 to Congress.

3 SEC. 806. SERVICE FEES.

4 (a) IN GENERAL.—Section 12 (7 U.S.C. 16) (as amend-
5 ed by sections 706 and 707 of this Act) is further amended by
6 adding at the end the following new subsection:

7 “(h)(1) Notwithstanding any other provision of law, the
8 Commission shall promulgate, after notice and opportunity
9 for hearing, a schedule of appropriate fees to be charged for
10 services rendered and activities and functions performed by
11 the Commission in conjunction with its administration and
12 enforcement of this Act.

13 “(2) Such fees shall reflect the cost to the Commission
14 of—

15 “(A) monitoring trading on the floors of designat-
16 ed contract markets to prevent and deter violations of
17 this Act;

18 “(B) supervising contract markets, futures associa-
19 tions, leverage transaction merchants, and other regis-
20 trants to ensure compliance with self-regulatory stand-
21 ards established under this Act;

22 “(C) analyzing and designating new futures,
23 option, or leverage contracts; and

24 “(D) such other services, activities, and functions
25 as the Commission finds appropriate for such fees.

1 “(3) In promulgating a schedule of appropriate fees
2 under this subsection to be assessed against persons benefit-
3 ing from services rendered or activities performed by the
4 Commission, the Commission may consider phasing in any
5 new or increased fees. In making such determination, the
6 Commission shall consider (A) the immediate impact on the
7 Federal budget of increasing the size and scope of the Com-
8 mission, and (B) the burden of other reasonable costs being
9 borne by such persons for purposes of such persons coming
10 into compliance with the standards of section 5a(13).”.

11 (b) CONFORMING AMENDMENT.—Section 26 of the Fu-
12 tures Trading Act of 1978 (7 U.S.C. 16a) is repealed.

13 **SEC. 807. APPEALS BY REGISTERED FUTURES ASSOCIATIONS.**

14 Section 17(i)(4) (7 U.S.C. 21(i)(4)) is amended by strik-
15 ing “(other than a registered futures association)”.

16 **SEC. 808. TELEMARKETING FRAUD.**

17 Section 17 (7 U.S.C. 21) is amended by adding at the
18 end the following new subsection:

19 “(r) Each futures association registered under this sec-
20 tion shall, subject to the approval of the Commission pursu-
21 ant to subsection (j), adopt a rule specifying the factors it will
22 consider in determining whether to issue a summary member
23 responsibility action or other disciplinary action to require a
24 member to adopt special supervisory procedures relating to
25 telephone solicitations for new futures or options customer

1 accounts. Such procedures shall require at a minimum that,
2 with respect to an individual with no previous futures or op-
3 tions trading experience who was solicited by telephone, the
4 member may not enter any order for such individual for a
5 period of not less than 3 days after the individual signs the
6 required acknowledgment of receipt of the applicable risk dis-
7 closure statement.”.

8 **SEC. 809. VENUE; SERVICE OF PROCESS.**

9 Section 22(c) (7 U.S.C. 25(c)) is amended by adding at
10 the end the following new sentences: “Any action brought
11 under subsection (a) may be brought in any district in which
12 the defendant is found or is an inhabitant or transacts busi-
13 ness, or in the district in which any act or transaction consti-
14 tuting the violation occurred. Process in such action may be
15 served in any district of which the defendant is an inhabitant
16 or wherever the defendant may be found.”.

17 **SEC. 810. STUDY OF DELIVERY POINTS FOR AGRICULTURAL**
18 **COMMODITY CONTRACTS.**

19 (a) **STUDY.**—The Comptroller General of the United
20 States shall conduct a study of the provision for, and func-
21 tioning of, delivery points regarding contracts of sale for
22 future delivery of any agricultural commodity to determine
23 whether the objectives of section 5a(10) of the Commodity
24 Exchange Act (7 U.S.C. 7a(10)) are being achieved. The
25 study shall also examine—

1 (1) whether the objectives of such Act relative to
2 such delivery points need to be revised;

3 (2) whether the availability and adequacy of stor-
4 age facilities for agricultural commodities at such deliv-
5 ery points affect prices;

6 (3) whether the number, accessibility, and volume
7 of storage facilities at such delivery points contribute to
8 consistency and reasonableness in price discovery in
9 the contract market;

10 (4) whether a system of delivery in cash under
11 such contracts of sale for future delivery would be fea-
12 sible and would further the public interest in hedging
13 and price basing for agricultural commodities;

14 (5) whether special concerns about the adequacy
15 of delivery are raised by the participation in such con-
16 tracts of international corporations whose commercial
17 needs for physical commodities may be global; and

18 (6) such other issues relating to such delivery
19 points as the Comptroller General determines relevant
20 to the efficient operation and improvement of contract
21 markets for agricultural commodities.

22 (b) REPORT.—Not later than 1 year after the date of
23 enactment of this Act, the Comptroller General shall submit
24 to the Committee on Agriculture of the House of Representa-
25 tives and the Committee on Agriculture, Nutrition, and For-

1 estry of the Senate a report containing the results of the
2 study conducted under subsection (a), together with any ap-
3 propriate recommendations.

4 **TITLE IX—EFFECTIVE DATE**

5 **SEC. 901. EFFECTIVE DATE.**

6 Except as otherwise provided in this Act, this Act and
7 the amendments made by this Act shall become effective on
8 the date of enactment of this Act.

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